AUDIT MANUAL Chapter 4



General Audit Procedure

Sales and Use Tax

Sales and Use Tax Department



September 1995

Chapter 4

Table of Contents

GENERAL AUDIT PROCEDURE	0400.00
INTRODUCTION	
GENERAL	
OBJECTIVE OF THE TAX AUDIT	
AUDIT SELECTION	
FORM BT-1164 AND FORM BT-1032	
AUDIT MEMORANDUMS CONCERNING STATE AGENCIES	
AUTHORITY — EXAMINATION OF RECORDS	
PUBLIC RELATIONS	
TAX AUDITING	
INTRODUCTION	
AUDIT APPROACHAPPROACH TO AUDITING CREDITS OR REFUNDS	
PROGRAMMING — AUDIT SURVEY	
STARTING AN ASSIGNMENT — GENERAL	
PRELIMINARY ARRANGEMENTS	
DISCUSSION WITH TAXPAYERCONTACTS WITH THIRD PARTY REPRESENTATIVES	
WRITTEN CORRESPONDENCE	
PRELIMINARY EXAMINATION	
PRELIMINARY TESTING	
SURVEY OF PLANT	
RECEIPT FOR TAXPAYER'S RECORDS	
AUDIT PROGRAM — PROCEDURE TO FOLLOW	
PLANNING THE AUDIT	
AUDIT PROGRAM	
EXPLORATORY TESTING	0404.15
MAKING THE AUDIT — PROCEDURES AND TECHNIQUES	0405.00
GENERAL	0405.05
AUDITS ON A TAXABLE MEASURE BASIS	0405.10
SHORT TESTS	0405.15
USE OF TEST BASIS	
BANK DEPOSITS	
MARK-UP METHODS	
CUT-OFF TECHNIQUES	
WHOLE DOLLAR AUDITING	
WORKING PAPERS	0405.45
MAKING THE AUDIT —	0400.00
APPLYING PROCEDURES AND TECHNIQUES	
GENERAL EXAMINATION OF GENERAL LEDGER ACCOUNTS	
EXAMINATION OF GENERAL LEDGER ACCOUNTS	
EXAMINATION OF GENERAL JOURNALEXAMINATION OF CASH RECEIPTS AND DISBURSEMENTS RECORDS	
EXAMINATION OF CASH RECEIPTS AND DISBURSEMENTS RECORDS	
EXAMINATION OF ACCOUNTS RECEIVABLE LEDGER	
SCHEDULE OF TOTAL SALES OR REVENUE	
GROSS PROFIT AND NET WORTH ANALYSIS	

Table of Contents (Continued)

MARK-UP BASED ON INCOME TAX RETURNS	
INCOME TAX RETURNS AS BASIS OF AUDIT	
EXAMINATION OF SALES OR REVENUE INVOICES	
SPECIALIZED TECHNIQUES-SALES AND USE TAX	0407.00
GENERAL	0407.05
MARK-UP METHODS	0407.10
SHORT TESTS	0407.15
VERIFICATION OF RECORDED TOTAL SALES	
CASH REGISTER SHORTAGES	0407.25
PURCHASES SUBJECT TO SALES OR USE TAX	0408.00
GENERAL	
METHODS OF VERIFICATION	0408.10
EXAMINATION OF PURCHASE INVOICES	
ASSERTION OF USE—TAX ON LEASES	
USE OF AUDIT MEMORANDUM ON SELLER (FORM BT-1164)	
USE OF AUDIT MEMO ON OUT OF STATE SELLERS (FORM BT-1032)	0408.22
CALIFORNIA USE TAX COLLECTIONS BY	
UNREGISTERED OUT-OF-STATE RETAILERS	
EXAMINATION OF SELECTED GENERAL LEDGER ACCOUNTS	
EXAMINATIONS OF JOURNAL ENTRIES AND REQUISITIONS	
FUNGIBLE GOODSUSE OR LOAN OF PROPERTY PURCHASED FOR RESALE	
AUDIT OF SALES FOR RESALE	
GENERAL	
METHODS OF REPORTING RESALES	0409.10
DEDUCTION SUPPORTED BY ACTUAL LISTS DEDUCTION CALCULATED	
DEDUCTION CALCULATED	
SELECTION OF THE BASIS FOR THE AUDIT	
DETAILED AUDIT — LIST OF CLAIMED RESALES AVAILABLE	
DETAILED AUDIT — LIST OF CLAIMED RESALES NOT AVAILABLE	
EFFECT OF "CONTRA" ITEMS ON DEDUCTIONS	
FOR SALES FOR RESALE	0409.45
ACCEPTABLE DOCUMENTARY EVIDENCE	
TO SUPPORT SALES FOR RESALE	0409.50
USE OF BT-504 — XYZ LETTER PROCEDURE	
WHEN GOOD FAITH OF SELLER IS QUESTIONED	
PURCHASE ORDERS AND RESALE CERTIFICATES	
MISUSE OF RESALE CERTIFICATE	
TAX BILLED BY VENDOR BUT DELETED BY PURCHASER	
VERIFICATION OF PAYMENT OF USE TAX BY PURCHASER	
AUDIT OF SALES TO THE U.S. GOVERNMENT	
GENERAL	
AUDITING PROCEDURE	0410.10
SALES TO FEDERAL EMPLOYEES USING	
U.S. GOVERNMENT BANKCARDS	
UNITED STATES GOVERNMENT SUPPLY CONTRACTS	0411.00

Table of Contents (Continued)

AUDIT OF CASH DISCOUNTS	0412.00
GENERAL	0412.05
ACTUAL CASH DISCOUNTS TAKEN ON TAXABLE SALES	0412.10
COMPOSITE PERCENTAGE OF DEDUCTIONS TAKEN	0412.15
PERCENTAGE OF TOTAL DISCOUNTS TAKEN	0412.20
TRADING STAMPS	
SALES PROMOTION PLANS	
SALES TAX INCLUDED IN CASH DISCOUNTS	
AUDIT OF RETURNED MERCHANDISE	0413.00
GENERAL	
METHODS OF CLAIMING THE DEDUCTION	
AUDITING PROCEDURE — DEDUCTION CLAIMED	
AUDITING PROCEDURE — DEDUCTION NETTED FROM SALES	
REHANDLING AND RESTOCKING CHARGES	
RETURN OF TAX REIMBURSEMENT	
EXAMINATION OF ACCOUNTS RECEIVABLE	
DEFECTIVE MERCHANDISE	
PRICE ADJUSTMENTS	0413.40
AUDITS OF SALES IN INTERSTATE OR	
FOREIGN COMMERCE	
GENERAL	
AUDITING PROCEDURE — SHIPMENTS OUT-OF-STATE	
AUDIT PROCEDURE — SHIPMENTS INTO THE STATE	0414.15
AUDIT OF DEDUCTION FOR LABOR	0415.00
GENERAL	
AUDITING PROCEDURE	0415.10
AUDIT OF SALES TAX INCLUDED IN SALES	0416.00
GENERAL	0416.05
AUDITING PROCEDURE	0416.10
TREATMENT OF EXCESS TAX REIMBURSEMENT	0417.00
GENERAL	
REFUNDS OF EXCESS TAX REIMBURSEMENT	
AUDITING PROCEDURE	
OFFSETS	0417.15
SPECIFIC APPLICATIONS	0417.20
AUDIT OF PRESCRIPTION MEDICINES	0418.00
GENERAL	0418.05
AUDITING PROCEDURE	
AUDIT OF OTHER DEDUCTIONS	0419 00
AUDIT OF BAD DEBT DEDUCTIONS — GENERAL	
AUDITING PROCEDURE	
SPECIAL SITUATIONS	
CREDIT FOR TAX PAID TO OTHER STATES, SECTION 6406 CREDIT	
TAX PAID PURCHASES RESOLD	
AUDIT OF CHARITABLE ORGANIZATIONS	
AUDIT OF WATERCRAFT EXEMPTION CERTIFICATES	0419.35
AUDIT OF EXEMPT SALES OF AIRCRAFT	
AUDIT OF EXEMPT SALES AND PURCHASES OF NEW OR REMANUFACTURED	,
TRACTORS, TRAILERS, OR SEMITRAILERS	
SALES TAX EXEMPTION FOR FOREIGN DIPLOMATS	
EXEMPT SALES OF FOOD PRODUCTS — THE 80–80 RULE	
AUDIT OF FOOD STAMP DEDUCTION	

Table of Contents (Continued)

AUDIT OF LEASES	0420.00
GENERAL	0420.05
AUDITING PROCEDURE	0420.10
TIMELY ELECTION	
ITEMS INCLUDED IN RENTAL RECEIPTS	
ITEMS EXCLUDED FROM RENTAL RECEIPTS	
SALE OF LEASED PROPERTY BY LESSOR	
REPAIR AND MAINTENANCE CONTRACTS	
FUEL USED IN RENTAL VEHICLES "WET RENTALS"	
AUDIT OF SALE AND LEASEBACK TRANSACTIONSAUDIT OF LEASE TRANSACTIONS WITH GOVERNMENTAL BODIES	
AUDIT OF MOTOR VEHICLE FUEL	
GENERAL	
AUDITING PROCEDURE	
METHODS OF VERIFICATION	
ACQUISITION OF EX-TAX GASOLINE	0430.20
AUDIT OF MOTOR VEHICLE FUEL RETAILERS —	
PREPAYMENT OF SALES TAX	0431.00
GENERAL	
REPORTING REQUIREMENTS	
AUDITING PROCEDURES	
PROCEDURES WHERE RETAILER IS ALSO A DISTRIBUTOR/BROKER	
LOCAL TAX ALLOCATION	
BAD DEBTS	
ELIGIBILITY FOR REMOVAL FROM PREPAYMENT STATUS	
CLOSE-OUTS WORKING PAPERS	
WORKING PAPERS	
SPECIAL MOTOR VEHICLE FUEL TRANSACTIONS	
RETAILERS WHO PREMIX OR BLEND	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR	
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL	0432.00 0432.10 0432.15 0432.20
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES	0432.00 0432.10 0432.15 0432.20 0432.25
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT	0432.00 0432.10 0432.15 0432.20 0432.25 0432.30
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS	0432.00 0432.10 0432.15 0432.20 0432.35 0432.35
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT	0432.00 0432.10 0432.15 0432.20 0432.35 0432.35
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND	0432.000432.100432.150432.200432.350432.40
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS	0432.000432.100432.150432.200432.350432.400432.45
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS —	
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS — PREPAYMENT OF SALES TAX	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS —	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS — PREPAYMENT OF SALES TAX	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS — PREPAYMENT OF SALES TAX GENERAL PREPAYMENT CREDITS	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR. CREDIT CARD SALES MASTER CONTRACT SALES. SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS. SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS — PREPAYMENT OF SALES TAX GENERAL PREPAYMENT CREDITS AUDITING PROCEDURE REPORTING ERRORS AUDIT WORKING PAPERS	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS PREPAYMENT OF SALES TAX GENERAL PREPAYMENT CREDITS AUDITING PROCEDURE REPORTING ERRORS AUDIT WORKING PAPERS BAD DEBTS	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS — PREPAYMENT OF SALES TAX GENERAL PREPAYMENT CREDITS AUDITING PROCEDURE REPORTING ERRORS AUDIT WORKING PAPERS BAD DEBTS LOCAL TAX ALLOCATION	0432.00
RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR CREDIT CARD SALES MASTER CONTRACT SALES SALES TO U.S. GOVERNMENT SALES TO LOCAL GOVERNMENTS SALES OF GASOLINE FOR USE IN AIRCRAFT SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS SALES TO AUTO LEASING FIRMS SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT REFUND OF SALES TAX ON STATE MVF TAX REFUNDS REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS AUDIT OF FUEL DISTRIBUTORS/BROKERS PREPAYMENT OF SALES TAX GENERAL PREPAYMENT CREDITS AUDITING PROCEDURE REPORTING ERRORS AUDIT WORKING PAPERS BAD DEBTS	0432.00

Chapter 4

Table of Exhibits

Audit Process Flow Chart	Exhibit
Form BT-1164 — Audit Memorandum of Possible Tax Liability	Exhibit 2
Form BT–1032 — Information Out-of-State Retailers	Exhibit 3
Policy and Procedure for Subpoena Requests	Exhibit 4
Sample Sales Tax Working Paper (Whole Dollar Auditing)	Exhibit 5
Form BT–504–A/B/C — XYZ Sample Letter	Exhibit 6
Federal Acquisition Regulations (FAR's)	
Form BT-379-A — Aircraft Exempt Sale Referral	
Form BT-837 — Affidavit for Section 6388 or 6388.5 Exemption	

CHAPTER 4

GENERAL AUDIT PROCEDURE

0400.00

INTRODUCTION 0401.00

GENERAL 0401.05

It is not the purpose of this manual to lay down rules so rigid the auditor is precluded from the exercise of independent judgment. Suggested procedures which conform to standard audit practices are presented with an explanation of the terms frequently used by tax auditors. The auditor should recognize, however, that there are many variations necessitated by application of the law, rules and regulations, taxpayer's methods of reporting, and types of records encountered. For these reasons, it is impractical to present procedures which will be applicable to all situations. The typical flow of the audit process is illustrated in **Exhibit 1**.

Specific reference is made to the glossary contained in Section **0490.00** for terms peculiar to tax auditing which are used in this chapter. The auditor is expected to have a good working knowledge of these terms. It is suggested that the auditor be familiar with the terms in the glossary prior to reading this chapter.

OBJECTIVE OF THE TAX AUDIT

0401.10

The primary objective of the tax audit is to determine, with the least possible expenditure of time, the correct measure of tax. The audit program also provides information and assistance to taxpayers, enabling them to complete returns and pay their taxes correctly and efficiently. Interpretations of the law and related regulations, which are obtained by taxpayers during the audit process, provide them with a basis for the proper reporting of future tax liabilities.

AUDIT SELECTION 0401.15

Each district has the responsibility of determining which accounts are to be audited.

The assignment of an audit does not always result in a completed audit. Preliminary testing (Section **0403.25**) may disclose that an audit is not warranted. The auditor will prepare a Form BT–596, Report on Account Being Waived for Audit, on such accounts. Additional information on Form BT–596 is included in Section 0212.00.

When deciding whether to waive or audit an account, the auditor should consider the following points:

- Are accurate and complete records kept?
- Does the markup on cost of goods sold appear adequate?
- Are the persons preparing tax returns familiar with the law and the rules and regulations pertaining to their particular business?
- Are the reported amounts reasonable considering the type of business, nature of the premises, the location in the community, etc.?
- Do the reported amounts vary materially from period to period?
- Is there a good system of internal control?
- Is the taxpayer's past record good?

When working on a field assignment, the auditor may discover other accounts which may not have reported their tax correctly. Such information should be communicated to the audit supervisor.

0401.20

An auditor may discover information in a taxpayer's records which indicates that a supplier or customer may not be reporting tax correctly. If so, a Form BT–1164, Audit Memorandum of Possible Tax Liability, (See **Exhibit 2**) should be prepared in duplicate setting forth the facts. The original is submitted to the audit supervisor and will be used as a basis for investigation; the duplicate remains with the working papers. A written report in narrative form may be used instead of Form BT–1164. (See Section **0408.20**)

If the seller has accepted a properly executed resale certificate in good faith, and the auditor questions whether the buyer has in fact purchased the merchandise for resale, the auditor should prepare a BT–1164 and check the block "Seller has valid (resale) (exemption) certificate from buyer on file." *The auditor must also attach a photocopy of that certificate to the BT–1164*.

When untaxed purchases subject to use tax from an out-of-state vendor are detected, the auditor should notify the Out-of-State District. Form BT-1032, Information of Out-of-State Retailers, is available for this purpose (See **Exhibit 3**). The original is forwarded to the Out-of-State District; the duplicate remains with the working papers (See Section 0804.22).

The importance of preparing audit memoranda cannot be overemphasized. It is valuable as an aid to audit selection and may aid in disclosing tax that would not otherwise have been paid. It is the duty of the auditor to prepare memoranda in appropriate circumstances.

The auditor should also be alert for activity in other business taxes for which the taxpayer may not have a permit.

As a courtesy to the district receiving an audit memorandum, the auditor should attach a copy of registration file (!RG 1) and the audit file (!AUD 1) from the BTCIS which contain necessary information for selecting and ordering an audit on the account in question. This information may also be useful to the auditor preparing the memorandum regarding the transaction in question, i.e. start date or industry code of the purchaser or supplier in question in the case of a questioned sale for resale.

AUDIT MEMORANDUMS CONCERNING STATE AGENCIES

0401.23

The Department of Finance no longer audits state agencies and therefore no longer receives or takes action on audit memorandums. Therefore, the audit memorandums prepared by auditors which involve state agencies should be distributed in the same manner as other audit memorandums.

The Out-of-State District in auditing out of state businesses should question any sales or leases to the State of California. If they find sales or leases subject to use tax in which the tax was not billed to the State or reported by the retailer, such sales or lease receipts should be assessed in the audit. Special care should be taken to accurately assess applicable local and district taxes.

AUTHORITY — EXAMINATION OF RECORDS

0401.25

Government Code sections enable the auditor to examine records of the taxpayer and of persons doing business with him.

The Government Code sections are:

- Section 15613 Issuance of Subpoenas
- Section 15617 Attendance Before the Board
- Section 15618 Examination of Records

A provision of the Government Code enables the Board to issue a subpoena for the attendance of witnesses or to produce books, records, account and papers.

The taxpayer must provide unconditional access to the records which are necessary for the auditor to perform the audit. If the taxpayer insists on placing conditions or limitations on the auditor's access to the records, a subpoena can be issued which will require the taxpayer to produce the necessary books and records. Issuance of a subpoena may be considered if the taxpayer insists on such actions as audio or videotaping all discussions between the taxpayer and auditor.

An auditor, by developing a good working relationship with the taxpayer, should rarely have to rely on a subpoena as a means of obtaining records. If a taxpayer refuses to make requested records available, or places undue restrictions or conditions on their use, the auditor's supervisor should be consulted immediately.

Requests for the issuance of subpoenas must be made by District Administrators and submitted to the Chief of Field Operations for approval and forwarding to the Legal Division. Further information concerning the subpoena process, authority and use is contained in **Exhibit 4** — Policy and Procedure For Subpoena Requests.

PUBLIC RELATIONS 0401.30

It is important that the auditor attempt to establish a good rapport with the taxpayer thereby encouraging a cooperative attitude.

The Board has established a basic policy which is clearly stated in Chapter 1. The complete compliance with this policy cannot be overemphasized.

The auditor should maintain an objective attitude, tempered by the fact that we are dealing with human beings. To the extent possible, the auditor should:

- Encourage a cooperative attitude by being cooperative.
- Maintain an "arms-length" relationship with the taxpayer in the sense of not becoming personally involved.
- Avoid arguing with the taxpayer.
- Avoid "humorous" remarks. These are frequently misinterpreted by the taxpayer.
- Avoid political and religious discussions.

Public relations are a factor during the entire course of the audit. The auditor should develop a sense of timing as to when it is best to discuss the various audit phases with the taxpayer; e.g., after agreement has been reached regarding appropriate test procedures with the taxpayer, no further discussion should be required until test findings are established or necessary changes in agreed procedure are required.

The auditors' appearance, clothing and conduct should be appropriate to their professional status.

There is one basic difference between tax auditing and public accounting: The public accountant is serving their client and is on the client's premises on the request of the client; the tax auditor's presence is usually not requested.

TAX AUDITING 0402.00

INTRODUCTION 0402.05

Tax auditing is defined as an inquiry into all phases of a taxpayer's business in which significant tax error could occur. Tests are made in accordance with generally accepted auditing standards. They are extensive or comprehensive only to the degree necessary to support a professional audit opinion as to the correctness of returns as filed. Tests of records where potential errors are small are normally not as comprehensive as tests where substantial errors are possible. Expression of the auditor's opinion or recommendation concerning all tax-significant phases of a taxpayer's business are reflected in two types of audit reports. These are:

- "No change" BT-414-C reports.
- "Change" BT–414–A reports recommending: (The section references here are to the Sales and Use Tax Law, see similar sections under the various tax acts for the appropriate law.)
 - Deficiency determination per Section 6481;
 - Determination No returns filed Section 6511;
 - Refund recommendation per Section 6901.

Very limited testing or sampling may be all that is necessary to support a "No Change" report or "No Change" phases of a "Change" report. Testing to support substantial change recommendations must include sufficient verification or explanatory comments so that the report is understandable and can be evaluated by other members of the staff as to the soundness of the auditor's opinion or recommendation (See Chapter 2 for investigations (BT–414–B) and field waivers (BT–596) which are short of a full report as contemplated by BT–414–C or BT–414–A reports.)

Auditors should make the most efficient use of their time by making full use of all available records and worksheets of the taxpayer. The auditor should schedule exceptions noted. This has the advantage of aiding the auditor in discussing the direct findings with the taxpayer. This procedure also helps to clarify the auditor's thinking so that they may relate the exceptions to the specific law and/or regulations.

AUDIT APPROACH 0402.10

Many taxpayers are careful to report taxable transactions accurately, especially after one or more audits have been made. To make an extensive examination of three years' operations in these situations may not be justified. Short tests should be made before starting a complete verification of three years' operations.

If these short tests indicate the taxpayer has not properly reported their tax liability, the auditor should make more extensive tests. The short test should be designed so that the result can be combined with more extensive tests to determine the proper measure of additional tax.

APPROACH TO AUDITING CREDITS OR REFUNDS

0402.20

A primary purpose of the Board's audit program is to provide reasonable assurance that taxpayers pay neither more nor less tax than required by law. Consequently, the Board is just as concerned with refunding overpayments as with collecting underpayments. If a refund situation is noted in the course of the audit, the auditor should normally secure a claim for refund from the taxpayer utilizing the BT–101, "Claim for Refund or Credit."

In most refund cases the taxpayer will be required to schedule all of the specific transactions upon which the tax was overpaid. This is part of the taxpayer's responsibility to record and report their tax liability accurately. The auditor will verify the accuracy and validity of the schedules using whatever audit procedures are appropriate in the circumstances.

If a taxpayer has under-reported their tax liability, the Board staff usually proposes to assess the additional tax based on appropriate sampling in order to reduce audit costs. As in the case of a refund, the taxpayer must schedule all of the specific unreported transactions for the audit period if they believe that the proposed amount of tax to be paid is excessive. Again, this is part of the taxpayer's responsibility to record and report their tax liability accurately. If the taxpayer has not reported accurately, and declines to correct the situation by scheduling all specific errors, it is reasonable for the Board to assess unreported taxes on the basis of sampling, or deny a refund of purported overpayments of taxes, rather than incur the costs of correcting the taxpayer's records. If the taxpayer does schedule all of the specific unreported transactions for the audit period, the auditor will verify the accuracy and validity of the schedules using whatever audit procedures are appropriate in the circumstances, just as in the case of schedules prepared to support a claim for refund.

This is a consistent approach to all cases in which the taxpayer has not recorded and reported their tax liability accurately, whether the tax liability was under-reported or over-reported. In either event, the taxpayer can reduce the tax liability reported to the Board, and/or assessed by the board, only by scheduling the reporting errors on an actual basis.

In some situations it may be appropriate to verify and recommend a refund on the basis of sampling rather than by requiring the taxpayer to schedule all of the specific transactions upon which the tax was overpaid. However, this may be done only if the refund does not involve transactions upon which tax reimbursement was collected from customers, the sampling is conducted in such a manner that there is a high degree of confidence in the result, and the amount to be refunded constitutes a conservative estimate of the amount overpaid. A refund should never be approved on the basis of a sample when sales tax reimbursement or use tax was collected from customers on the transactions upon which the refund is based since all specific transactions must be identified in order to refund the tax to the customers. When a refund is recommended on the basis of sampling, the taxpayer should be required to do most of the work to conduct the test.

The completion and transmittal of audit reports recommending refunds must be given urgent priority since the interest paid on refunds usually exceeds the interest earned on state funds. Each district must establish permanent procedures for the early identification and control of audits involving refunds so that such audits are completed and transmitted without unnecessary delay.

PROGRAMMING — AUDIT SURVEY

0403.00

STARTING AN ASSIGNMENT — GENERAL

0403.05

Usually an assignment should be started only after proper arrangements have been made in advance. In rare instances, it may be desirable to start an assignment without notifying the taxpayer, as in the case of a surprise investigation of a person suspected of fraudulent reporting practices.

If the necessary records are located in another district or subdistrict, the audit assignment normally should be transferred to that district or subdistrict along with Form BT–579. This form should be accompanied by a fact sheet setting forth as much pertinent information as is available, including any audit memoranda, that will assist the receiving office in completing the case. The auditor's supervisor may, in unusual circumstances, make arrangements for the auditor to make the audit at the other location.

PRELIMINARY ARRANGEMENTS

0403.10

Certain preliminary steps to be taken before starting an assignment are:

- a) If available, examine the district master file to determine type of business, starting date, ownership, close outs, reorganizations, and general record of reporting; and to review refund notices, delinquencies, audit memos, etc. Any pertinent information will be recorded on Form BT-414-Z (Section 0208.86).
- b) Contact the taxpayer to arrange for:
 - Exact time for starting assignment.
 - Records to be supplied for start of assignment.
 - Name and position of person to be contacted (*The auditor must leave their name and telephone number with the taxpayer at this time.*)
 - · Desk space.
- c) Verify registration information, including:
 - Insuring current ownership is the same as the permit. Sole proprietors may not know that becoming a partnership or incorporating is a change in ownership.
 - The accuracy of the assigned area code(s).
 - The accuracy and currency of all subpermits.
 - The correctness of the taxpayer's allocation procedures.
 - Any other area(s) which could impact the accuracy of the reported local tax.

If any errors are discovered, the auditor is to take *immediate* corrective action including:

- obtaining the date when the change or error first occurred
- preparing a BT–1047, "Notice to Change Account Record" (or other form as required by District Compliance) if an area code change is required
- notifying Compliance of new or closed-out subpermits

The appropriate BT–80 series "Audit Engagement Letter" should be used to confirm arrangements to begin audits or to establish contact with the taxpayer.

Normally the initial contact with the taxpayer will be by telephone. When the audit appointment results from a telephone contact, the appointment must be immediately confirmed by mailing the BT-80-A, "Confirm Start Date" letter together with Pamphlet No. 70, "The California Taxpayers' Bill Of Rights", and Pamphlet No. 76, "Audits and Appeals", unless the audit will commence within a week of making the appointment.

In that case the letter and pamphlets may be given to the taxpayer at the start of the audit. If the audit appointment is with the taxpayers' representative, the engagement letter (with enclosures) should be sent to the taxpayer, with a copy to the representative.

The auditor should grant reasonable requests by taxpayers to delay the starting of an audit, but should be alert to detect attempts to forestall it. If a delayed start date is agreed to, and a period is about to outlaw, the BT–80–B, "Agreement to Delay Start Date" should be used, enclosing in addition a "Waiver of Limitation" (BT–122) covering a minimum of two calendar quarters (Section 0215.00). If the audit is a result of a claim for refund filed by the taxpayer, a form BT–146, Waiver of Credit Interest, should be obtained.

If the auditor is unable to contact the taxpayer by telephone, the BT–80–C, "Initiate Contact" letter should be used, and if necessary followed up with the BT–80–D, "10-day follow up" letter.

DISCUSSION WITH TAXPAYER

0403.15

When the auditor arrives at the taxpayer's place of business at the appointed time, they should have a preliminary discussion with the taxpayer or with the person who has charge of the records before starting the audit work. A representative tax return should be examined, and the taxpayer should be requested to point out the source of the figures used to compile the return.

The auditor should determine, by direct questioning of the taxpayer, the exact nature of the business activity for the audit period. Inquiry should be made about changes in key clerks, accountants and/or accounting systems, as variations in the type of business, or in the methods of conducting business will have an effect on the approach to making an audit.

CONTACTS WITH THIRD PARTY REPRESENTATIVES

0403.17

In order to protect the taxpayer, it is imperative that before any discussion or correspondence is initiated with a person claiming to be a representative of the taxpayer, the auditor secure written authorization from the taxpayer. It is not generally necessary to obtain this authorization when the taxpayer introduces or refers the auditor to their representative. It is also not necessary to obtain an authorization when the representative is a professional governed by a code of ethics, e.g., a certified public accountant or attorney. However, it is a good practice when contacted unilaterally by a professional to acknowledge the contact in writing with a copy to the taxpayer. The taxpayer should receive copies of all correspondence concerning their case.

WRITTEN CORRESPONDENCE

0403.18

The staff should confirm in writing any significant verbal contact or agreements with the taxpayer or their representative which involve:

- Delays in appointments.
- Records that are not available.
- Requests for supporting documentation.
- Requests for books and records.
- Requests for delay of audit work.
- Confirmation of meetings to discuss audit findings.
- Other contacts significant to the audit.

By use of this procedure, the taxpayer will be kept aware of the progress of the audit. When corresponding directly with the taxpayer's representative, a copy should always be sent to the taxpayer.

This is the point at which the auditor takes "inventory" of all potential information sources. Unless the method used in reporting is entirely erroneous, audit time will ordinarily be saved by adapting the audit procedures to the taxpayer's reporting methods. The auditor should ask the taxpayer to produce the desired records. These may be:

- General Ledger
- General Journal
- Sales Journal or Revenue Journal
- Purchase Journal
- Duplicate returns and working papers supporting them.
- One or more months original documents, e.g., sales invoices, and purchase invoices.

In addition to the above listed records the auditor should question the taxpayer relating to such specifics as:

- Internal controls.
- Systems in use.
- Summary records, etc. (Including income tax returns.)

If such preliminary examination of records indicates that substantial portions of the necessary documentation are not available (such as resale certificates), the auditor should advise the taxpayer what further data is needed and postpone starting the audit until this information has been obtained. Consideration should be given to securing a "Waiver of Limitation", Form BT–122.

When making larger audits, other information will be helpful, such as:

- The names of employees with whom the auditor will have contact.
- A list of all books and records in use and the name and location of the person in charge of the particular records.
- A list of sources of taxable transactions and how they are accounted for in the records.
- An explanatory chart of accounts.
- An explanation of the physical layout of the plant or the type of operations.
- Outside accountants' reports, if available.
- Minute book, if a corporation.
- Copies of Federal and State income tax returns.

Where the taxpayer has not prepared detailed schedules in substantiation of reported amounts, such as, purchases subject to use tax and deductions, the auditor should request they prepare such schedules for the periods to be test-checked. Ordinarily, a listing of the detail in chronological sequence showing invoice numbers and amounts of each transaction will be sufficient. Additional information may be required in some cases and the auditor should advise the taxpayer as to the extent of the required information and the form in which it is to be submitted.

On completion of the above, potential areas of misplaced tax should now begin to form in the auditor's mind.

PRELIMINARY TESTING

0403.25

The auditor has now reached the point where a decision must be made to proceed with the audit or whether the audit should be waived as non-productive.

Informal spot or random tests of records and returns should be made for projection purposes. To be meaningful, the tests should be short and as widely spread over the audit period as possible, emphasizing periods where there were significant changes in:

- Personnel
- Accounting methods, and
- Types of transactions

Such a test may consist of an examination of one return selected at random, verification of the figures entered thereon, and tracing the figures to the books of original entry. It also should consist of an examination of a representative number of sales or revenue tickets and the tracing of the amounts shown on the ticket to the appropriate journal. Tests should be made of purchase invoices covering supplies and expense items. A more detailed examination should be made of equipment purchases. Tax accrual accounts in the General Ledger should be examined for possible irregularities. Revenue accounts should be tested for disclosure of possible unreported sales. Similar short tests should be made to verify the accuracy of the amounts claimed as deductions. If the results of these tests indicate the taxpayer has been properly reporting the tax, the audit report should be completed using Form BT–414–C, or Form BT–596 (see Chapter 2).

The test may result in a no change audit report or a waiver of audit assignment or the verification of certain phases of the assignment (e.g., sales for resale, etc.) The testing techniques result in actually probing into all facets of the taxpayer's business activity relating to the records maintained and the taxpayer's knowledge and understanding of the particular tax act or acts under which they operate. If this preliminary testing does develop an area of misplaced tax, then a more formal and expanded test should be developed as discussed in subsequent sections of this manual.

SURVEY OF PLANT 0403.30

In auditing a small concern, the auditor can usually look over the place of business without making a tour of the premises. In an audit of a large firm they should ask to be shown through the plant and office. This need not be done immediately. In fact, it is preferable to wait until the audit is started and the auditor has become familiar with the accounting system. This survey will help the auditor to understand many features of the operation such as the method of securing and billing orders, the method of making nontaxable sales, the processes in which material is consumed, and the use of equipment and machinery possibly purchased from out-of-state source. All of this will enable the auditor to design the audit program more intelligently. In case of widespread complex operations, the extent of the tour may be limited.

RECEIPT FOR TAXPAYER'S RECORDS

0403.35

Whenever a taxpayer leaves their records at a board office or whenever records are picked up in the field and removed from the taxpayer's premises, a Receipt for Books and Records, Form BT–945, will be used. Receipts will be made in duplicate, the original being given to the taxpayer or representative and the duplicate retained in the working paper file. In preparing the form, care should be taken to adequately describe the books and records.

When the books and records are returned to the taxpayer or representative, the original receipt should be obtained with proper signature of taxpayer or representative affixed thereto indicating their return. If the original receipt is not available, the duplicate copy retained by the staff should be used to obtain receipt for return of the material listed thereon.

If the taxpayer wishes the records sent to them this should be done in such a way that the Board has their written instructions and a record of the shipment. The taxpayer should be asked to pay the shipping charges if they are excessive.

If the taxpayer does not respond to normal attempts to return the records, a letter should be sent to the taxpayer by certified mail at the address given on Form BT–945. This should notify them that the records are no longer needed and unless they call for them or advise where to ship them with 15 days, they will be destroyed as authorized by the taxpayer on Form BT–945. In most instances such letters will be returned undelivered since they will only be sent after other means of communication have failed. To allow an ample margin of time there should be no actual destruction of records until at least 30 days after mailing the certified letter. After 30 days, if the taxpayer's records can serve no useful purpose in connection with the tax obligation, they should be removed from the files and disposed of in the same manner as other records the destruction of which has been authorized. A record of such destruction, together with copies of Form BT–945 and the certified letter, should be retained.

AUDIT PROGRAM — PROCEDURE TO FOLLOW

0404.00

PLANNING THE AUDIT

0404.05

This section presumes that as a result of the preliminary probing and testing as described in Sections **0403.20** and **0403.25** the auditor has become aware of a potential area of misplaced tax. It is now the function of the auditor to:

- a) Determine whether the correct amount of tax has been reported; and
- b) If not, what is the amount of misplaced tax.

Any good auditing procedure that will expeditiously achieve this end result is the preferred procedure. The auditor must set up and design an adequate test program.

There are two basic approaches to this problem which may be named and defined as:

- a) Direct Audit Approach auditing the formal accounts and records of the taxpayer.
- b) Indirect Audit Approach where reliance cannot be placed upon the formal accounts. Illustrative of the indirect audit approach is any method used to impeach the records, e.g., mark-up of purchases, bank deposits, independent sources, etc., whether formal records are kept or not.

Depending upon the audit approach found necessary the auditor should:

- a) Establish a test base,
- b) Establish test periods and,
- c) Come to an understanding with the taxpayer to the extent possible as to:
 - Reasonableness of test approach.
 - Assistance to be furnished by taxpayer in assembling or preparing test data, e.g., sales invoices, vendor's invoices, resale certificates, or E.D.P. runs as necessary.

AUDIT PROGRAM 0404.10

All audits are guided by an organized plan. This plan is influenced by the results of the preliminary investigation, surface examination of the records and limited testing procedures. The plan may be informal such as the review of the records of a small account or formalized where audit problems are complex and a high degree of control by the auditor in charge is desired.

The tentative audit program originally laid out will need to be modified as work progresses. If many errors are found in any test, it should be expanded so that a good base for calculating a percentage of error will be available. On the other hand, if no errors are developed in the first period tested, if the records are in good condition, and if the personnel are well informed on the correct application of the tax, oftentimes the testing may be terminated with one period. The auditor must use their judgment based on observations of the records, plant and personnel to decide just how much verification is required.

All testing is exploratory in nature and even though preliminary testing did indicate that further testing was necessary, continuing errors are not always supported by additional testing.

The auditor is to be continuously alert to discontinue testing at the earliest possible moment they are able to determine that further testing is unwarranted. This is a cut-off technique which is discussed fully under Section **0405.35**. In cases of this nature, the working papers will contain appropriate comments regarding the test procedure used and the findings.

This expanded testing differs from the "spot" or "random" tests discussed in Section **0403.25** in that controls are established so that projections can be made to estimate the amount of the misplaced tax. The word "estimate" as used here means the results of the test when applied to the audit period.

The "controls" mentioned here involve test periods, etc., and will be more fully discussed in Section 0405.20.

Note should be made of the fact that tests sufficient to support a no change recommendation may well be short of the testing degree and completeness necessary to sustain a change recommendation.

MAKING THE AUDIT — PROCEDURES AND TECHNIQUES 0405.00 GENERAL 0405.05

After having determined an account should be audited it is necessary to devise an audit program. To do this, the auditor should be familiar with tax auditing techniques. The auditor should be alert to the possibility of revising the use and application of such techniques as the need arises.

Some of the special techniques and procedures are:

- Short tests.
- Use of test basis.
- Bank deposits.
- Cut-off techniques.
- Whole dollar auditing.

These procedures and techniques are described in the following sections.

AUDITS ON A TAXABLE MEASURE BASIS

0405.10

An audit made on a taxable measure basis generally places emphasis on the verification or accumulation of taxable differences as compared to an audit performed on a total sales and claimed deduction basis using individual lead schedules.

The use of the taxable measure basis should in no way be construed as relieving the auditor of his responsibility to verify that all sources of revenue and deductions have been examined or of writing verification comments thereon. Comments should cover fully the nature of the transactions verified, the audit procedure used in making the verification and the result.

There are certain cases where the taxable measure basis may be preferable:

- Where records are available, but verification of the total gross reported and deductions is not significant. The taxable transactions are few in number and the taxpayer has reported taxable measure only based on a listing of these transactions, capitalizing tax reimbursement, or by mark-up of taxable purchases.
- Where the total gross reported is not an important factor in determining taxable measure. This may apply, for example, for sales tax purposes, to service enterprises, contractors, public utilities, manufacturers and wholesalers.
- Where the records are such that an indirect audit approach is necessary and the taxable measure must be reconstructed. (See Section **0404.05**)
- Where the taxpayer has prepared returns on a taxable sales basis and audit time can be conserved by conforming to this method.

As an example, where a grocer has used a method other than the "grocers method" to arrive at the taxable measure or the overall mark-up, as reflected by recorded gross sales, is unfavorable, our audit might be conducted in a more efficient manner through a verification of taxable sales.

Although total gross reported loses much of its significance in audits prepared on a taxable measure basis, a comparison between recorded and reported total gross is important, for it may disclose that sales, gross receipts, or fuel used, for one month or one department or branch of a business was not included in the reported totals. This comparison also may disclose classes of transactions or use erroneously considered nontaxable by the taxpayer. If the comparison between recorded total gross and reported gross discloses unreported taxable transactions, these items should be listed on a schedule.

If the taxpayer has reported on the basis of lists or tapes of taxable items, the auditor should verify the correctness of these lists by:

- Verifying that the lists include all items regarded as taxable by the taxpayer and
- Determining if there were any items subject to tax not so regarded by the taxpayer.

If the taxpayer has reported on a basis of tax actually charged to the customer and has credited the amount charged to a tax accrual account, the clerical accuracy of the posting to that account, as well as the computations made in converting the tax accrued to taxable measure should be verified. This will involve tests of:

- The computations of tax charged on customer's invoices.
- The posting of tax charges to the sales journal or other record where such charges are summarized.
- The clerical accuracy of the footings and the posting of the tax charges to the tax accrual account.
- The mathematics of the conversion of tax charged to taxable measure reported.

Debits to the accrual account should be scrutinized to determine that these charges represent proper deductions from the amount of tax accrued. Debits may include but are not limited to items such as:

- Payments to the Board
- Tax on cash discounts, returned sales or rescinded sales
- Tax refunded due to an overcharge or erroneous charging of tax on an exempt transaction

In addition the auditor should determine the effect on the accrual account of allowable bad debts, tax-paid purchases resold and other adjustments which legitimately reduce the taxpayer's accrued tax liability. Many accounting systems fail to adjust the tax accrual accounts for transactions of this type.

A reconciliation of the tax accrual account and the tax reported should be made, and a summary of the tax accrual account should be prepared and included in the audit working papers when material to the audit findings. Consideration should also be given to sales and use taxes collected for and paid to other states, for tax credit allowable under Section 6406 of the Sales and Use Tax Law, and for taxable self-consumed merchandise reported on Line 2 but not credited to the accrual account.

It is important that deductions claimed or netted be tested to the extent that the auditor is satisfied that they are allowable. Test procedures should be similar to those used when auditing on a total sales basis. Tests made should be as short or extensive as warranted under the particular circumstances involved. Schedules for deductions should be indexed in accordance with the system outlined in Sections 0302.50 to 0302.65.

Self-consumed merchandise and purchases subject to use tax should be audited in accordance with instructions included in Sections **0408.05** to **0408.40**.

General or over-all verification comments should be written on summary schedules. Specific verification comments should be written on subsidiary schedules.

The auditor should recognize that not all audits should be made on a taxable measure basis. When it is necessary to verify total gross less allowable deductions, or in those audits where it is necessary to prepare lead schedules in order to reconcile recorded and reported amounts, the audit should be made on a total sales basis.

SHORT TESTS 0405.15

Short tests are discussed in prior and succeeding sections, under Preliminary Testing (0403.25) and under Specialized Techniques for the various tax acts. It is the purpose here to discuss short tests as a technique.

The end result of a short test is a decision as to whether to proceed or to accept as correct that item being tested. If we decide to proceed the short test may be expanded to anything from a short period controlled test to, on occasion, a complete examination.

A short test may be defined as the examination of any record, supplemental data, original detail, etc. for any purpose. A short test audit may be a combination of several short tests. A short test might be, for example, review of an income tax return to see if the mark-up over cost is acceptable for the type of business, a spot check of sales invoices for proper tax accrual, etc. if the foregoing mentioned mark-up test indicates an acceptable margin and total sales per the income tax return agree with total sales reported per the sales tax returns, total reported sales might be accepted. Deductions might be accepted as claimed if, as a result of spot checking various transactions in detail (e.g., a resale sales invoice may be traced to its segregation in the sales journal as a resale, then to claimed resales, and finally to the individual resale certificate), no exceptions are noted.

A short test may be used to substantiate the auditor's recommendation for a no-change phase of an audit such as acceptance of recorded and claimed sales for resale in a sales tax audit which might be a change audit for other reasons.

The nature of the short test places a great deal of emphasis on the individual auditor's judgment. The auditor must be able to intelligently evaluate the results of a short test and come to a decision as to what to do. It is recognized that there is a "calculated risk factor" involved in arriving at a decision not to proceed. In a few cases the decision may be in error. If the auditor arrived at the decision as a result of good logic, properly presented, they need not be unduly concerned if it is later found that some misplaced tax did exist.

To prevent misunderstanding, one other type of short test should be discussed. In certain businesses where the number of transactions are large (e.g., department stores), it may be necessary to design a controlled test for a short period. An example might be the operations of one day or less. This test, even though formal in nature vs. spot checking, would be construed as a short test because this forms the basis of a decision to stop testing or to proceed. If it is decided to proceed this original test might be the nucleus of an expanded audit program.

USE OF TEST BASIS 0405.20

An audit made on a test basis is one in which the transactions of only a part of the audit period are examined in detail. The balance of the period is adjusted on the basis of the findings in the test periods. Such findings are usually expressed in terms of percentages of error calculated from the errors and differences disclosed in the test period. This basis assumes that the differences disclosed in the test period, which are audited in detail, will occur in the same proportion in the balance of the audit period.

- a) When to use a test period. There are certain conditions necessary before a test can be used. These are:
 - Units of sale or the amounts of the items of claimed deductions are uniform as to size and distribution throughout the audit period.
 - Basic characteristics of the business and the methods of reporting remain the same throughout
 the audit period. Should the basic characteristics of the business change during the audit period,
 separate tests should be made for each specific period with attendant percentages of error for
 each.
 - The sample audited in detail contains sufficient items to make possible an accurate percentage calculation. In other words if the sample tested has only a few transactions, errors may not lend themselves to a percentage calculation of reasonable accuracy.
- **b)** The test base. It is important to establish a clearly defined test base. There are two main points to consider:
 - The setting of a period or sample to be tested and
 - To establish what is being tested.

It is important that a firm sample be established so that a percentage of error can be computed and applied. This is, in effect the denominator, the differences found in the denominator being the numerator.

For example, if sales for resale are to be tested for one month all recorded and claimed resales must be examined for that month with exceptions or differences to allowable resales being noted. It follows that what is being tested is equally important. If the item being tested is sales for resale, only resales should be considered in this particular test. If the auditor finds a sale in interstate commerce erroneously recorded and claimed as a sale for resale, this should be eliminated from the test base and all factors influencing the calculation of a percentage of error.

It may be that what is being tested is a hodgepodge of various deductions. In this case, the base would be all the deductions recorded and claimed. The most expeditious approach may then be to revert to taxable sales as the base. The auditor should ascertain that all invoices for the test periods are available for examination. Verification should then be made in accordance with the taxpayer's method of computing the claimed deduction.

If the taxpayer's method has been to capitalize the tax collected, the auditor should examine invoices representing sales to verify that:

- The tax has been properly computed and added to taxable invoices;
- The tax so computed has been properly accrued in the sales tax accrual account, and
- that the tax so accrued had been remitted to the State.

All exceptions noted will be scheduled and summarized and the disallowed deduction for the entire audit period will be computed.

If the method used by the taxpayer is to deduct the sum of the taxable sales from total sales and claim the residual amount as a deduction the auditor should verify the taxable sales only. Any exceptions should be scheduled and a percentage of taxable sales understated should be computed based on the relationship the additional taxable sales bear to total taxable sales reported. The percentage thus computed will be applied to reported taxable sales in all periods other than those listed. Use actual additional taxable sales determined for the test periods. This method is not practical when the taxable sales are very small or when they fluctuate greatly from month to month. In such case it may be necessary to base the percentage on deductions claimed rather than on taxable sales.

The procedure under both of these methods is in effect auditing on a taxable sales basis (0405.10).

- c) Size of test period. The auditor must use their experience and exercise judgment in determining the size of test periods. The following principles should be considered in selecting a test period:
 - The size should be adequate to insure reasonable accuracy.
 - The auditing time required should not be excessive in relation to the problem.

In general, when auditing a business with good internal control, and a good accounting system, the test period may be a relatively small portion of the total audit period. However, in an audit of a business with little or no internal control, the test period should cover a larger proportion of the audit period. If records are available, the periods selected for test should be spread over the entire audit period so that samples can be taken of all years and all seasons of the year. The size of each test period, in addition to the above considerations, will depend on the number of documents required to be examined. Usually the test periods should consist of complete months or quarters, but periods of less than a month may be selected if daily or weekly controls can be established.

Statisticians have established that several short tests over the audit period are superior to one equivalent long period. For example, a test of three scattered months throughout the audit period will give better results than a one-quarter test.

d) Application of the test results. The percentage of error obtained in the test period may be calculated and applied to the entire audit period in the following manner:

Taxable sales reported (July 19xx)	\$5000.
Additional taxable sales disclosed (July 19xx)	750
Percentage of error \$750/\$5,000	15%
Taxable sales reported (Audit Period)	150,000
Additional taxable sales = (\$150,000 x 15%)	22,500

The percentage of error would, of course, be applied to the reported taxable sales for each quarter in the audit period.

If taxable sales of a nonrecurring nature are disclosed when auditing on a test basis, those sales should be excluded from the calculations of a percentage of error. For example, if a claimed resale ascertained to be taxable is of a nonrecurring nature, all sales of a similar nature should be examined for the entire audit period and the total of such sales deducted from claimed resales in the appropriate reporting periods and shown as a separate amount in the measure of additional tax. The percentage of error developed in the test periods should then be applied to the adjusted resales claimed for all periods in the audit not covered by the test. For example:

Total claimed resales in test periods	\$10,000
Nonrecurring taxable sales excluded	<u>4,000</u>
Adjusted resales	\$6,000
Other claimed resales disallowed	1,200
% of disallowance of adjusted resales (\$1,200/\$6,000)	20%*

^{*} To be applied to adjusted resales.

- e) Elimination of nonrecurring items. In making a test of the taxpayer's records to determine their accuracy, differences are sometimes found which do not appear to be a type, either in size of the transaction, kind of product sold, omission due to an unusual situation, or other reasons to include with the other differences found which are to be used in computing a percentage of error. These are normally items of considerable size, and the opposition to including them in the percentage of error is quite strong. Before handling these items as nonrecurring errors, they should be carefully scrutinized to see that they meet the requirements for nonrecurring errors. It is suggested that an error of this nature should meet one or more of the following conditions:
 - The size of the item is much in excess of the normal item and occurs only at rare intervals.
 - The item was omitted or included due to some unusual circumstance.
 - The product sold is a type not ordinarily handled.

In any instance where an item is found in a test which would result in a distorted answer and has an element which is out-of-the-ordinary, it can be considered, for classification, as nonrecurring. The fact that no other sales were made to that particular customer should not be considered a reason. Sufficient tests should be made in other periods to establish that items of a similar nature have not occurred.

f) Alphabetical vs. chronological filing of detail to be tested. It will be found that some firms file their sales invoices on an annual alphabetical basis, the sales being posted to the books of original entry chronologically.

The auditor in this situation can trace the sales for resale (if again this is the item being tested) back from the sales journal to the invoice then to the resale certificate. This is a time consuming process and may be short cut by:

- Spot testing the accuracy of posting as a sale for resale.
- Determine a test base by relating to dollar volume (i.e., a one-month test may be estimated in terms of dollars by dividing total claimed resales by the number of months).
- Selecting every third, fourth, or fifth, etc. letter of the alphabet as appropriate to approximate the desired number of dollars.
- Schedule exceptions noted and in terms of dollars schedule every invoice examined; this will give a firm base for the calculation and application of a percentage of error.
- If the auditor makes the audit soon after the start of the taxpayer's accounting year, the alphabetical invoice file may provide a reasonable size test period.
- g) Statistical sampling techniques. The use of statistical sampling as a means of testing has some very real advantages. The Board encourages testing with statistical sampling techniques if it is feasible. Statistical sampling is fully discussed in Chapter 13.
- h) Discussion with the taxpayer. The auditor should, whenever possible, discuss the use of test periods with the taxpayer and endeavor to obtain a concurrence. Often such a discussion will be of material assistance in selecting representative test periods and the test base.
 - **Caution:** It is suggested that the auditor avoid undue discussion with the taxpayer concerning the results of any preliminary tests at this point in the audit. Discussion may tend to place the taxpayer on the defensive and cloud the issue in attempting to arrive at objective test periods.
- i) Use of a test basis with no supporting detail. An audit made on a test basis where there is no supporting detail (i.e. no detailed journals) is conducted similarly to a detailed audit where there is no support for the claimed amount. However, the taxpayer should be requested to prepare supporting schedules for the test periods only. Invoices submitted by the taxpayer should be examined in detail and all transactions verified in the usual manner. The difference between the amount verified and the amount claimed will be disallowed in the same manner and to the same extent as in a detailed audit, and a percentage of overstatement of the deduction will be computed. This will be true regardless of whether complete details of the claimed deduction have been furnished.

For example:

\$2,500
\$ <u>2,300</u>
\$200
\$2,000
\$500
20%*

- This percentage of disallowance is to be applied to all periods of the audit other than the test periods. (Actual amount disallowed will be used for the test periods.)
- (j) Deleting sample elements as a result of a reply to an XYZ Inquiry. In a verification test of resales where a sample of the vendor's sales for resale is questioned, situations may develop as a result of the nature of replies from purchasers in which consideration must be given to deleting an element from the test sample.

When a purchaser's reply to an XYZ inquiry is that use tax has been or is to be paid to the Board and it is apparent the action was taken after the receipt of notification that the sale was being questioned, that element of the test should be retained as part of the sample from which a percentage of error will be developed. This audit approach recognizes that similar transactions have occurred in the untested periods and that those purchasers will not receive such notification and not be prompted to report and pay the use tax to the Board. However, an adjustment for the actual amount of the tax reportedly paid by the purchaser should be made in the vendor's audit.

In those cases where the purchaser replies that the tax has been paid to the Board and it is apparent that payment was made prior to receipt of notification that the sale was being questioned, the reply should not be counted as an error. However, the questioned transaction *should* remain in the sample base on which the percentage of error is computed.

There may also be cases where the purchaser's statement is questioned after checking the permit information on BTCIS. The auditor may find that the item has been in inventory for an extended period of time, or the purchaser is in a line of business not normally selling such items, or the purchaser has reported no or very low sales. In such situations, the auditor should not reject the response without performing further verification. If the auditor does not accept the reply to the XYZ letter as support for the claimed sale for resale, the questioned transaction should remain part of the sample.

In all of these situations a BT-1164 should be prepared, advising the district office in which the purchaser's account is located that the purchaser either has indicated that the use tax was or is to be paid on the questioned sale(s) item(s) or that the item(s) is still held in resale inventory.

BANK DEPOSITS 0405.25

In cases where the taxpayer has maintained a bank account, the bank deposits may be a more accurate source of determining gross receipts than recorded figures. There are two methods of estimating gross receipts on the basis of bank deposits:

- a) Where records of deposits are available for the entire period, they should be scheduled for that period.
- b) Where records of deposits are available only for a portion of the audit period, a percentage of error should be computed and then applied to recorded or reported sales for the remainder of the period.

In either method, the bank deposits should be scheduled by months from the bank statements, from the bank deposit books if verified as reflecting all deposits, or from data furnished by the bank. The record of cash deposits must be adjusted for certain types of transactions which will affect total receipts, viz.:

Increases:

Cash expenditures and withdrawals from cash receipts before bank deposits are made.

Decreases:

Deposits representing receipts from sources other than sales, i.e., loans, redeposits of NSF checks, rental income.

Other:

The auditor should be alert to such items as possible trade-ins, returns of merchandise sales, etc.

If the taxpayer has a record of cash pay-outs, the totals by months should be scheduled. If no such record exists, pay-outs for merchandise sometimes can be estimated by examining the check record or canceled checks to determine which types of merchandise are paid by bank checks. For instance, a restaurant may pay by check for meats, groceries, produce and dairy products, but pay cash for its daily needs of bakery goods, soft drinks, candy, etc. The latter purchases, as well as cash withdrawals, may be estimated after a conference with the taxpayer.

Credits for loans and increases in capital must be supported by documentary evidence in the form of canceled notes, letters from banks, savings bank books showing withdrawals, etc. The non-taxable receipts must be traced to bank statements to verify the amount and date of those deposits. Where vending machines are on the premises, copies of statements of settlement from the operators can be used to verify income from these sources.

In most cases, when this method of estimating receipts is used, either no record of accounts receivable is available or accounts receivable balances are so small they are not taken into account.

When there is a record of accounts receivable and there is an increase in receivables between the beginning and end of the audit period, the increase should be added to the last quarter. In unusual cases, where the increase is a large factor in the audit, it should be prorated to quarters.

The auditor should at all times be alert for evidence of bank accounts for which the taxpayer has not produced statements or deposit books.

Bank deposits are useful in determining gross receipts for sales tax audits. They are somewhat less useful in highway tax audits.

Bank deposits may also be used as a short test to see if there is a reasonable relationship between cash receipts and recorded gross receipts; their use otherwise would be as an indirect audit approach.

MARK-UP METHODS 0405.30

Use of mark-up methods as an audit procedure is widespread in sales tax auditing but of little or no use under the various other tax acts administered by the Board. In view of this, markups as such are discussed under specialized techniques for sales tax (see **0407.10**).

The auditor is cautioned not to rely too heavily on mark-up percentages (cost of goods sold divided into gross profit) for all types of businesses. It may be time consuming to obtain and have little meaning. For example, in a wholesale business having little in the way of taxable sales, a mark-up percentage calculation would have little meaning.

CUT-OFF TECHNIQUES

0405.35

"Cut-Off" is that point in the audit program where the auditor has accumulated sufficient data to support a reasonable conclusion or opinion based on acceptable audit standards. It might be defined as when to stop. This may refer to the audit as a whole or to a specific task or test. This is a judgment area for the auditor. For example when a short test indicates an error, but an expanded test does not seem to sustain this error, the auditor must stop and analyze why this condition exists, whether to continue testing and on what basis, etc.

When a prospective cut-off point is reached a decision should be made whether to accept the test results, alter the audit approach, or discontinue the audit. In terms of testing, the audit approach or testing program may be altered by:

- a) Expanding the test base by inclusion of additional test periods.
- b) Narrowing the test base because the results do not disclose significant error. For example:
 - Cut-off detail examination of certain invoices to examine only those over a given amount.
 - Cut-off detail examination of certain invoices to examine only those for certain customers or vendors as the case might be.

Important points to consider in deciding whether to cut-off, alter the audit approach, or discontinue completely are:

- a) Materiality of error encountered.
- b) Frequency of error.
- c) Blind alleys:
 - Source detail missing.
 - Change in filing system.
- d) Discovery of a more efficient approach, e.g., change from invoice testing to an accounts payable examination selection of certain vendors. This will be found to be equally applicable to sales invoices and accounts receivable.
- e) Arrival at an opinion prior to completion of the test as originally planned.

WHOLE DOLLAR AUDITING

0405.40

The principle of dollar auditing (i.e., dropping cents) is a time-saving technique. In whole-dollar auditing, cents are eliminated at the earliest practical stage in an accounting sequence and only whole-dollar amounts are recorded thereafter.

- a) Rules that apply when rounding to whole dollars:
 - Eliminate cents between \$.01 and \$.49 (e.g. \$7.18 becomes \$7)
 - Increase to next dollar, cents between \$.51 to \$.99 (e.g. \$5.72 becomes \$6)
 - Round \$.50 amounts to the nearest even dollar (\$17.50 becomes \$18; \$18.50 also becomes \$18).

Do not show a decimal point or place figures or symbols in cents columns when amounts are rounded to whole dollars.

b) Treatment of variances:

The sum of whole-dollar amounts will often differ by a few dollars from the sum of the exact amounts. For tax auditing purposes, this is not important since the variance in terms of tax is negligible.

These small variances (usually less than \$5) will be dropped at the first convenient place they can be identified in the working papers. Variance differences standing alone are easily discernible. Variance differences commingled with clerical errors or errors on returns are not easily discernible and need not be dropped.

An example of a column to eliminate rounding variances in lead schedules is shown in Exhibit 5. In some cases, it is possible to drop readily identifiable variance differences in subsidiary schedules.

- c) Common situations where whole-dollar auditing *should not* be used are:
 - When a taxpayer objects. A brief explanation to the taxpayer may overcome this objection.
 - When computing tax, penalty and interest.
 - When computing markup from shelf tests.
 - When basic data must be compiled with accuracy to avoid distortions when the findings are expanded, e.g., computing a percentage of error.
 - When items to be scheduled do not reflect normal distribution of fractional dollar amounts, such
 as when repetitive purchases at one given price are made, or when sales are made under a policy
 of pricing at only slightly less than whole dollars.

WORKING PAPERS 0405.45

Chapter 3, Audit Working Papers, contains the basic information relating to audit working papers.

Usually each portion of an audit, viz., total sales, self consumed merchandise, sales for resale, etc., should be considered as a separate unit with separate working papers for each unit.

MAKING THE AUDIT — APPLYING PROCEDURES AND TECHNIQUES

0406.00

GENERAL 0406.05

While the basic tools given to the auditor in this chapter are guides, there is nothing which will replace initiative, ingenuity and judgment in applying, adapting and improvising as necessity warrants.

The following sections briefly describe the books, records and detail that the auditor will normally encounter in making audits. All or part of these described records may be used in performing any given audit and they may be used in either a direct or indirect audit approach.

EXAMINATION OF GENERAL LEDGER ACCOUNTS

0406.10

The general ledger accounts must be examined for debits and credits which may represent unreported taxable transactions. As examples, sales of merchandise at cost may have been credited to the purchase or inventory accounts; sales of by-products may have been credited directly to profit and loss, surplus or expense accounts; sales of furniture, equipment and other capital assets may have been credited to equipment, depreciation or other accounts. Debits to general ledger equipment and supply accounts may represent unreported purchases subject to use tax.

EXAMINATION OF GENERAL JOURNAL

0406.15

Transactions not disclosed by examination of other records may sometimes be disclosed by examination of the general journal. The auditor should examine general journal entries noting those which may indicate unreported taxable transactions.

All data pertaining to these entries should be examined; such as, correspondence, contracts, invoices and other documents to determine whether the entry represents an unreported taxable transaction.

EXAMINATION OF CASH RECEIPTS AND DISBURSEMENTS RECORDS 0406.20

The cash receipts record should be examined to determine that receipts from cash transactions have been credited to the proper sales or revenue accounts. Care should be exercised not to duplicate taxable transactions disclosed in the examination of other records.

EXAMINATION OF ACCOUNTS RECEIVABLE LEDGER

0406.25

The accounts receivable with the owners, partners, officers, or employees of the company should be examined for evidence of taxable transactions not otherwise recorded in the sales or revenue accounts. Partners' drawing accounts and employees' advance accounts should be examined.

EXAMINATION OF PURCHASE JOURNAL

0406.30

Entries may be made in the purchase journal for sales at cost or returned merchandise. Inventory withdrawals which should have been reflected in the inventory accounts may appear as credits in the purchase journal. These postings should be scrutinized for taxable transactions.

SCHEDULE OF TOTAL SALES OR REVENUE

0406.35

Unnecessary scheduling should be avoided. However, good auditing procedure should always be kept in mind. Time can usually be saved by reconciling the sales or revenue reported to the general ledger accounts. Taxable differences, where encountered, can be transferred to the Schedule 414–A2, Summary of Differences.

In some cases, it is more practical to trace the reported figures to the sales or revenue journal or general ledger by periods. If there are frequent differences appearing, it would be advisable to schedule total sales or revenue. If there are only a few isolated differences, the periods where the differences occur should be scheduled. When the recorded figures can be used in tying-in several items such as total sales and several deductions, a detailed schedule of total sales may be advisable. This may be scheduled from the sales journal if the segregation between taxable and nontaxable sales are not shown in the general ledger.

Where the sales are scheduled from the sales journal or other detailed sources, the scheduled figures should be reconciled with the general ledger.

In all cases, proper planning is necessary to determine the correct method to be used for the assignment. Verification comments should always indicate the general method of reconciliation used.

GROSS PROFIT AND NET WORTH ANALYSIS

0406.40

The auditor will encounter some cases where the taxpayer has no records of any kind, or perhaps only fragmentary records. Where this condition exists, sales must be estimated as accurately as possible based on whatever information is available. In order to estimate sales, it must be assumed that gross profit equals increases in capital assets, operating expenses, and net withdrawals of the proprietor. Algebraically, this is expressed as follows:

- a) Gross Profit = Sales minus Cost of Goods Sold
- b) Cost of Goods Sold = Gross Profit ÷ by Mark-Up %
- c) Mark-Up Percentage = Gross Profit ÷ Cost of Sales
- d) Gross Profit = Capital Asset increases + Expenses + Withdrawals
- e) Sales = Cost of Goods Sold + Capital Asset increases + Expenses + Withdrawals

The items to be determined are:

- Percentage of mark-up
- Capital asset increases, operating expenses and withdrawals.

The percentage of mark-up may have to be estimated based on auditor's knowledge of mark-ups of similar type and size of business located in the same general area. If at all possible to do so, a mark-up should be computed based on current purchase invoices which may be available. This mark-up could then be compared to the known mark-up of similar businesses as a test of its accuracy.

Increases in capital assets, operating expenses and the proprietor's net withdrawals must be compiled from data and estimates based on information derived from questioning the taxpayer and other persons who have knowledge of the business. Information regarding increases in capital assets may be obtained by noting new equipment, machinery, etc., and determining the equity held by the taxpayer, etc. Average operating expenses may be estimated from canceled checks of records of expenditures; wages may be taken from social security records; rent from rental agreements. Withdrawals by the proprietor may be estimated from canceled checks, bank deposit books, investments, etc.

MARK-UP BASED ON INCOME TAX RETURNS

0406.45

In many instances, income tax returns are no more accurate than the records from which they are compiled. The income tax returns, however, may be of aid to the auditor in supporting sales estimated by using one of the methods outlined above. For example, where the taxpayer's records have actually been lost or destroyed, the income tax returns may be compared with the sales estimated by using procedures set forth in Section **0406.40**. This procedure is, of course, based on the premise that at the time the income tax return was compiled the taxpayer was in possession of their records. Where there is a discrepancy between the purchases and sales per the records and the purchases and sales per the income tax return, the taxpayer should be requested to account for such differences. Consideration must be given to purchases and receipts which do not represent sales of tangible personal property.

INCOME TAX RETURNS AS BASIS OF AUDIT

0406.50

Where a taxpayer has acceptable records, but gross receipts recorded in the books and reported on business tax returns are not in agreement with gross receipts on the income tax returns, these differences should be reconciled if possible. In making this reconciliation differences due to netting of, for example, sales tax from gross receipts per the sales tax return should be recognized. Another example of this would be reporting for income tax purposes on a cash basis vs. an accrual basis for sales tax purposes.

EXAMINATION OF SALES OR REVENUE INVOICES

0406.55

Sales or revenue invoices usually represent the original record of a transaction after an order of execution, such as a purchase order has been given. In the process of most of our audits under the various tax acts it is a necessary part of the audit procedure to examine a representative number of these invoices to determine how the transaction is recorded thereon and in the case of reimbursable taxes, on what the tax was accrued.

Following is an itemization of the various functions involved in the examination of this original detail:

- a) **Postings.** This is the first step in the verification of the accuracy of the books of original entry. The invoice, sales or revenue, is vouched directly to the sales or revenue journal for accuracy of posting relative to amount and classification in the journal.
- **b) Tax accrual.** On those taxes subject to reimbursement (i.e., sales and use tax the tax as accrued on the invoice is important for reasons such as:
 - Accrual of the tax based on the measure, i.e., sales tax rate times the selling price. This would relate to audits verifying the taxpayer's reporting on an accrual of tax basis, and
 - The provisions of Regulation 1700 of the Sales and Use Tax Law concerning excess tax reimbursement.
- c) Deductions. At the time the invoice is being reviewed for posting accuracy, etc., it also, will be reviewed for evidence of exemption from the particular tax concerned. For example, under sales tax if the sale is being claimed exempt as a sale for resale the resale certificate itself could at that time be examined.
- **d)** What is the form of the invoice, i.e., are the charges segregated; are they lump sum charges, etc.? The importance of this will relate to the particular tax act. For example, sales tax vendors are, under certain conditions, allowed to bill lump sum where they consider themselves to be consumers rather than retailers of the personalty used in repairing tangible personal property.
 - In summary, it cannot be overemphasized that the sales or revenue invoice is of prime importance in the audit process and any information found thereon is worthy of consideration; the importance then extends from the document itself to what is done with it in the process of recording.

SPECIALIZED TECHNIQUES-SALES AND USE TAX

0407.00

GENERAL 0407.05

A tax auditor is concerned primarily in ascertaining whether the reported tax liability is substantially correct.

When it is determined that a taxpayer's records are such that sales cannot be verified by a direct audit approach the auditor must estimate the sales from whatever information is available. The following sources of information and procedures have been found useful in determining probable sales:

- Bank deposits (Section **0405.25**).
- Gross profit and net worth analysis test (Section **0406.40**).
- Income tax returns (Section **0406.50**).
- Purchases plus mark-up (Section **0407.10**).

If enough information is available to do so, the auditor should use two or more of these methods to estimate the sales, comparing the results of one method against the results of another.

Note should be made of an additional factor which might be considered when the propriety of the recorded sales is questioned. This is the net profit. A continuing low net profit or loss would be indicative of a possible understatement of total sales. The value of this consideration is substantive only to other findings.

MARK-UP METHODS 0407.10

Mark-up procedures to determine audited sales (i.e., gross sales, sales of a deduction or taxable sales) are a vital part of sales tax auditing. There may be some other limited uses of this procedure under the various tax acts but since its use is primarily under sales and use tax it will be discussed in full here. The auditor should expand on this use whenever the opportunity presents itself.

Mark-up, sometimes expressed as mark-on, is the amount added to cost to obtain the sales price, and generally is referred to in terms of percentages. The percentage of mark-up is computed by dividing gross profit by cost of goods sold: G.P./C.G.S. = % of M.U. Taxpayer's often discuss gross profit in terms of percentages based on sales but seldom discuss mark-up based on cost. Care should be exercised by the auditor to make certain they are on common ground with the taxpayer when discussing gross profit and mark-up percentages.

Mark-up factor is the factor by which cost of sales is multiplied to determine total sales: C.G.S. x M.U.F. = S. The mark-up factor always will be the percentage of mark-up plus 100%. In computing sales, the mark-up factor should be used as it saves one step (adding the amount of the mark-up to cost of sales) in the computation of sales. The mark-up factor is obtained by dividing sales by cost of goods sold: S./C.G.S. = M.U.F.

Before proceeding one other point should be made. Mark-up as previously discussed may be used to determine sales; it may also be used as a short test in examining the mark-up produced by the taxpayer's records. Is this mark-up satisfactory for the type of business involved? If it is, this may satisfy as verification of total sales, etc. This same technique may be used to verify a deduction. For example, sales of food products in a liquor store.

A mark-up test and/or procedure to determine sales is only as reliable as the base from which the auditor is working or in other words, purchases or if available, cost of goods sold. Verification of purchases is discussed in a subsequent paragraph.

In many types of businesses, particularly where the unit of sales is small, the volume of transactions relatively large and the mark-up does not fluctuate greatly, the sales may be estimated with a fair degree of accuracy by establishing the mark-up from a shelf test and applying the computed mark-up to the cost of sales. This procedure applies to audits of such concerns as restaurants, small retail stores of all kinds, and under certain conditions, to audits made on the basis of taxable sales. The following items must be considered in this type of audit:

- a) The determination of total purchases.
- b) The segregation of purchases between departments or types of merchandise having the same general level of mark-up.
- c) Self consumed merchandise.
- d) Shrinkage of inventory.
- e) Inventory adjustments.
- f) The computation of mark-up for each department or class of merchandise.

Verifying total purchases (Item a). Where a record of purchases is available, the monthly or quarterly totals should be tied-in for the entire audit period. These should be proved and the recorded purchases compared with purchase invoices on a test basis to insure that total purchases have been recorded. In many cases, however, a record of purchases will not be available. Under those circumstances, the purchase invoices should be scheduled for a test period. The auditor should make sufficient tests to determine that all purchase invoices are on hand. Recommended tests are:

- Scrutinize accounts payable for names of vendors with no supporting invoices.
- Ascertain names of brands and types of merchandise carried by a personal inspection of the stock and compare with invoices submitted by the taxpayer.
- Examine canceled checks or check stubs.
- Examine record of cash paid outs.
- Examine vendor's monthly statements for completeness of invoices.

When the auditor is doubtful that all purchase invoices are available, purchases for a test period should be obtained from a representative number of vendors. If it is found that the taxpayer's records are incomplete, some or all of the purchases should be obtained from all vendors' records. This procedure should be used in extreme measures only as it is usually very time consuming.

Segregation of purchases (Item b). If there are widely different mark-ups in the various departments or types of merchandise, the purchases, if possible, should be segregated into classes to facilitate the application of appropriate mark-ups. Before adopting this procedure, however, the auditor should make sure that the purchases can be so segregated. If they cannot, an average weighted mark-up applicable to all purchases should be computed.

Following are some of the frequently used segregations:

- a) Drug Stores
 - Proprietary drugs (non-prescription)
 - Ethical pharmaceuticals
 - Drug sundries
 - Tobacco products
 - Notions, stationery and supplies
 - Liquor
 - Fountain supplies

- Food products
- Newspapers and magazines
- b) Service Stations and Garages
 - Tires and tubes
 - Oil
 - Grease
 - Parts
 - Accessories
 - Batteries
 - Gasoline
- c) Liquor Stores
 - Distilled spirits
 - Beer
 - Wine
 - Food
 - Tobacco products
 - Newspapers and magazines
 - Other merchandise
- d) Clothing Stores
 - Garments
 - Accessories
 - Shoes
 - Miscellaneous merchandise

Self-consumed merchandise (Item c). The recorded cost of goods sold should be reduced by the cost of merchandise consumed by the taxpayer, given to employees, or given to customers for promotional purposes. If self-consumed quantities are not supported by the records, a reasonable estimate should be made with the assistance of the taxpayer.

Shrinkage of inventory (Item d). An allowance should be made for pilferage, spoilage, theft and fire losses where applicable. When shrinkage is present, an amount of up to 1% of the cost of these items may be allowed. When the taxpayer claims shrinkage of more than 1% they must substantiate the amount. This substantiation may consist of reports from regularly employed security guards, private detective agencies or similar service firms as well as losses computed through sales and inventory reconciliation's.

In the absence of detailed data, a reasonable estimate of pilferage, spoilage, theft, or fire losses may be made based on available data from:

- Police reports.
- Insurance claims and settlements.
- Inventory (for fire loss and large theft claims).
- Type, size and location of store and availability of inventory for pilferage.

When a merchandise shrinkage allowance is given, it should be set out as a separate item; not buried in the mark-up used. (See the illustration under item "f" — Calculation Mark-up)

Inventory adjustments (Item e). In many cases, the taxpayer will not have inventories which can be checked for accuracy. In this event, the purchases may be considered the cost of sales if there is evidence that inventories were substantially constant.

Inventory adjustments are especially critical in making audits on new businesses, and close-out businesses. If adjustments are not made it may result in assessing tax on goods not yet sold.

Calculation of mark-up (Item f). The accuracy of an audit based on purchases marked up to selling prices depends principally upon two factors; the correctness of cost of sales and the accuracy of the calculation of mark-up. The cost and selling price must be known to compute the mark-up.

This procedure contemplates the auditor will make an actual examination of price tags, price stickers, signs or any other device used to inform the customer of the unit sales price.

In those instances where the audit is not made at the taxpayer's place of business or when it is either impractical or impossible to determine the taxpayer's posted unit sales prices, the auditor should use standard catalogs or price lists. For example, when auditing liquor stores under these circumstances, the auditor may use the retail prices listed in Patterson's Guide, or the Beverage Industry News.

If all items sold are marked up by approximately the same percentage, a straight average may be used. However, if the mark-up on the several classes of purchasers varies materially, a mark-up should be computed for each of the classes or a weighted mark-up be computed. The weighted mark-up is usually based on dollar volume of purchases although the units purchased and units sold method may be used to an advantage in certain instances. The most commonly used methods of computing mark-up are in order of preference:

- 1) Weighted average; purchases of one or more purchasing cycles.
- 2) Segregation of classes of merchandise.
- 3) Average of selected items.

Effect should be given to mark-downs where they can be established.

Mark-up for periods outside of the audit period may be used when current records are so incomplete as to prohibit establishment of a current mark-up.

The calculation of mark-up, based on cost, is illustrated by the following example:

Sales			\$25,000
Cost of Sales:			
Inventory 1-1-xx		\$2,000	
Purchases		20,606	
		\$22,606	
Inventory 12-31-xx		<u>7,000</u>	
Cost of Sales per Books & Records		\$15,606	
Adjustments:			
Self Consumed	\$400		
Shrinkage (pilferage)	<u>156</u>	<u> </u>	
Adjusted Cost of Sales			15,050
Gross Profit			\$ 9,950
Mark-up = 9,950/15,050 = 66.11%			

Mark-up based on weighted average (Item 1). Total purchases for at least one purchasing cycle should be used to determine the weighted mark-up. Depending on the type, size and purchasing habits of the business, a purchasing cycle could cover a period from one week to six months. When the purchase invoices have been pulled for the test period, the taxpayer should be requested to price all invoices at retail. Those prices should

then be test checked with shelf or list prices. The total purchase price and total sales prices of each invoice can then be recapped and from the total costs and selling prices, a percentage of mark-up can be computed. This percentage can be applied to quarterly cost of sales if such figures are available, to estimate quarterly sales. If quarterly totals are not available, the percentage of mark-up can be applied to cost of sales on an annual basis and any understatement of taxable sales developed can then be allocated to the quarters in each year on a sales ratio basis.

Mark-up based on purchase segregation (Item 2) This method of computing a mark-up is best suited to retail stores whose merchandise categories are few in number, sharply defined and with a wide variance in mark-up and sales volume. Purchases must be recorded in a manner which will allow verification of segregation in a minimum amount of time, not only for the test period but the entire period being audited. The auditor will determine the cost price and sales price of each category of merchandise for a representative test period.

Individual mark-ups will be computed for each class of merchandise. The percentages of mark-up thus computed will be applied to their respective purchase category over the entire period of the audit. Before using this method, the auditor must determine that an accurate segregation of purchases can be made over the entire audit period. If such segregation is not possible, this method should not be used. Wherever inventories are available, the mark-up is to be applied to cost of sales. Otherwise, purchases may be considered to be cost of sales.

Mark-up based on average of selected items (Item 3). This method of computing the overall mark-up may be used in certain types of businesses where the units of sale are generally small and the mark-up and sales volume of the various kinds of merchandise handled do not vary materially. The use of a straight average mark-up computed from shelf prices of representative items will usually be sufficiently accurate for this kind of audit. Such items should be included in the computation approximately in proportion to the volume of each class of merchandise handled. Slow moving merchandise and unusual merchandise not regularly sold should not be used in computing the mark-up. The percentage of mark-up computed should be applied to cost of sales for the audit period. Any substantial error in reporting revealed by a comparison of sales computed by this method and reported can be allocated against all quarters of the audit period on a percentage basis. If adequate records are not available to reflect cost of sales for the audit period, representative periods may be selected to compute estimated sales. The results of these periods can be projected to all periods on a percentage of error basis.

When sales computed by a mark-up method indicate only a small understatement, sound judgment must be exercised in concluding whether the difference actually represents an understatement rather than inaccuracies in the mark-up procedure. In reaching such a conclusion, consideration should be given to all available facts.

In addition to the foregoing, the auditor is referred to other chapters of this manual for specific application of mark-up methods and techniques; such as, Chapter 8, Bars and Chapter 9, Grocers.

SHORT TESTS 0407.15

The tax returns of some types of small concerns may be proved approximately correct or incorrect on a short test basis (0405.15) by verifying certain essential information. Listed below are examples of the types of information which may be considered in short tests:

- a) Small markets or grocery stores.
 - Records show an adequate mark-up on cost.
 - Purchases subject to use tax were properly reported.
 - Computation of the food product deduction on an over-all basis for the period of audit show it to be reported substantially correct.
 - That the ratio of taxable sales to total sales is approximately correct after giving consideration to the size, type, and location of the store.

- b) Small service stations and garages.
 - That taxable sales reported appear to be correct based on observation of size, type, location and size of inventory of taxable merchandise.
 - That purchases subject to use tax, such as grease, tools and supplies have been reported.
 - That taxable and over-all mark-up is satisfactory.
- c) Small retail stores.
 - That bank deposits, after adjusting for nontaxable income, and cash paid-outs are in agreement with reported sales.
 - That sales tickets show proper application of tax.
 - That over-all mark-up is satisfactory.
- d) Small restaurants and lunch stands.
 - That purchases include all types of food ordinarily sold in the business.
 - That the mark-up is satisfactory.
 - That the deduction for food products for consumption off premises is reasonable and properly supported.
- e) Bars.
 - That sales computed based upon mark-ups determined from short tests, applied to merchandise purchases on an over-all basis are in reasonable agreement with those reported.
 - That self-consumed taxable merchandise as reported is adequate for this operation.

VERIFICATION OF RECORDED TOTAL SALES

0407.20

If recorded sales have been scheduled or reconciled with reported sales, sufficient verification should be made to prove their accuracy and to disclose any taxable sales not entered in the regular sales account. Additional taxable sales developed in this examination should be scheduled on a subsidiary schedule if few in number. However, if numerous unreported sales in different sales categories are disclosed, a separate subsidiary schedule should be used for each class of unreported transactions.

CASH REGISTER SHORTAGES

0407.25

Questions are frequently raised about amounts classified as "cash register shortages". Factors which may cause differences between sales recorded on the cash register and cash and valid sales checks received are as follows:

- 1) Sales are rung on the cash register incorrectly, are then re-rung correctly, but the sales clerk fails to cancel (void) the first ring.
 - Erroneous duplicate over-rings are allowable as a reduction of sales.
- 2) Sales are recorded on the register for more than the actual sales amount; for example, a \$1.00 item rung on the register as \$10.00. The reverse (under-rings) also occur.
 - Over-rings and under-rings are to be treated as a reduction or addition to sales recorded on the cash register.
- 3) Charge sales checks have illegible or missing credit card imprints or handwritten customer names. (These are billed as an unidentifiable receivable and subsequently written off to cash register shortage.) Illegible charge sales checks are considered as worthless or uncollectible accounts. Accordingly, such uncollectible sales qualify as a bad debt deduction. However, any amounts which are subsequently collected should be reported.
- 4) Charge sales checks are lost prior to billing.
 - Charge sales checks lost prior to billing are considered as uncollectible accounts qualifying as a bad debt deduction.

5) Employee or other theft from register.

These amounts are not allowable as a reduction of sales. When money is stolen, there is not a question as to whether or not consideration was received.

- 6) Charge sales checks indicated by sales person as cash and therefore never billed to the customer. These are considered to be worthless accounts similar to items 3 and 4.
- 7) Counterfeit money received.

Sales paid for by counterfeit money, fraudulent checks or unauthorized charge plates are allowable reduction of sales. However, the reduction is limited to the original sales amount. Losses attributable to counterfeit money or fraudulent checks in excess of the original sale are not allowable.

8) Cash register change errors.

Change errors are not to be treated as an adjustment to recorded cash register sales. Such errors are similar to lost or stolen money. The change error occurs after consideration for the merchandise has been received. Any recourse against a customer who has received excessive change would be based on the fact that they have money which belongs to the store. It would not be based on lack of consideration received for the merchandise purchased.

Differences which are claimed as a reduction of cash register sales must be supported by the facts on hand. The analysis of a representative test period should, in fact, substantiate that any one, or a combination of the factors enumerated, does support a reduction in cash register sales in the amounts and to the extent claimed.

PURCHASES SUBJECT TO SALES OR USE TAX

0408.00

GENERAL 0408.05

The auditor must be alert to distinguish between sales tax and use tax in order to assert the tax liability properly. Generally, the sales tax is the liability of the seller, whereas the use tax is the liability of the purchaser. A retailer who consumes merchandise purchased for resale under a valid resale certificate or any person who consumes merchandise purchased from a retailer the sale of which is exempt from sales tax, is liable for the use tax on the cost of the property purchased. In the latter case the purchaser's liability is not extinguished unless they have paid the tax to the State, or to a vendor who is authorized or required to collect the use tax and has issued a receipt to the purchaser.

If a purchaser certifies in writing to a seller that the property purchased will be used in a manner or for a purpose entitling the seller to regard the gross receipts from the sale as exempt from the sales tax and uses the property in some other manner or for some other purpose, the purchaser shall be liable for payment of sales tax as if the purchaser were a retailer making a retail sale of the property at the time of such use and the sales price of the property to the purchaser shall be deemed the gross receipts from such retail sale.

Many consumers neglect to report taxable purchases because a satisfactory method of accumulating these purchases is not used. The auditor should be particularly vigilant in examining purchase order, purchase invoices, requisitions and journal entries for evidence of use tax.

METHODS OF VERIFICATION

0408.10

Based on the type of business and the condition of the records, there are three general methods of procedure used in establishing purchases subject to use tax:

- Examination of purchase invoices, requisitions, journal entries and inventory credits.
- Examination of debits to selected general ledger accounts and tracing the entries back to the purchase invoices or other documents of original entry.
- In some businesses such as small bars and small groceries a reasonable estimate may be used.

EXAMINATION OF PURCHASE INVOICES

0408.15

Invoices for a representative period, depending on the volume, should be examined and compared with the purchase record to determine that all invoices are on hand. Either all purchases that are considered taxable should be scheduled, or if details of reported amounts are available, the purchases should be traced to the taxpayer's working papers and only the omitted items need be scheduled. A copy of the schedule should then be submitted to the taxpayer for verification. The taxpayer may be able to prove that the questioned items were not subject to the tax or were reported in another quarter. If the results of the test prove the taxpayer is reporting all items correctly, this phase of the examination should be discontinued. If, however, the test indicates improper reporting the test may be expanded, possibly to cover the entire audit period.

After having examined several months' invoices, the auditor should be familiar with the names of vendors who supply the taxpayer with resale merchandise only or those vendors who consistently charge tax on consumable items as well as those vendors who do not charge tax on consumable items. Thereafter, the examination of invoices can be limited to those issued by vendors in the latter category. Frequently the "miscellaneous" file for each letter of an alphabetic file is a source of purchases subject to use tax.

An examination of purchases for capital expenditures should be made in detail only as the transactions are generally few in number with a relatively high unit value. Furthermore, such purchases usually are not made at regular intervals or in consistent amounts.

Wherever possible, estimate purchases of supplies, expendable tools, etc. based on a test period. This is particularly true in types of businesses where the consumable supplies bear a direct relationship to units produced or sold, e.g., coke used in the cupola process for producing steel, advertising material used in sales promotion, grease used in lube jobs, etc.

General Audit Procedure / Chapter 4 / September 1995

The monthly amounts of merchandise so consumed can be determined by an examination of several months' purchase invoices. When this method is used, the taxpayer should be consulted and approval secured, if possible. (See Chapters 8 and 9 for discussions regarding purchases subject to use tax in restaurants and grocery stores, respectively.)

In instances where a voucher number system is used for accounts payable and filed in numerical order by years, it will be necessary to control any test, beyond either spot checking or a complete year's examination of invoices, working from the voucher register to the invoices. A dollar volume test as described under Section **0405.20** might be used here if it is not practical to make a test from the voucher register. Invoices filed alphabetically by years may be examined (short of spot tests or complete review) by working from the distribution thereof in the purchase journal or check register. That is, specific expense account distributions may be reviewed or tested back from the book of original entry to the invoices. Here, again, as suggested in the foregoing a dollar volume test might be developed.

ASSERTION OF USE—TAX ON LEASES

0408.17

In general, use tax will only be asserted against the lessor since it is difficult to determine from the lessee's records whether the lease is a "sale" under the Sales and Use Tax Law. Therefore, a review of the lessor's records is necessary to determine if any tax liability exists. In addition, such a procedure insures that lessors are properly permitized and reporting the tax. Whenever the audit of a lessee reveals that tax has not been collected by the lessor, and the auditor cannot determine that tax was properly due, an audit memorandum (BT–1164 or BT–1032) should be prepared and sent to the lessors district. The auditor should not assert tax against the lessee.

An exception to the above general policy is that tax may be assessed against the lessee if the lessor is located out-of-state and does not have a California seller's permit, and the property being leased is **not** mobile transportation equipment (MTE). If tax is assessed, a BT-1164 or BT-1032 should be sent to the lessors district showing the amount of tax assessed and the applicable periods.

USE OF AUDIT MEMORANDUM ON SELLER (FORM BT-1164) 0408.20

In making an examination of purchase invoices, it frequently will be noticed that the California vendor has not charged sales tax on some or all of the invoices issued and the purchaser has not issued a purchase order marked "for resale" and states that a resale certificate has not been issued to the vendor. The nature of the merchandise will sometimes be sufficient evidence to indicate that a resale certificate, if timely given, was not taken in good faith; e.g., where a retail jewelry store purchased janitorial supplies or a service station purchases a commercial type hydraulic jack. If in doubt, and the amount involved is substantial, the auditor may contact the vendor to determine whether the vendor holds a valid resale certificate. In the event the vendor does not have a valid resale certificate, the tax should not be determined against the purchaser. Rather, a Form BT–1164, (see Section 0401.20) should be prepared, in duplicate, setting forth the pertinent facts about the transaction. The original will be used as a basis for investigating the vendor. The duplicate will remain with the working papers.

The auditor also should use a Form BT–1164 where it is determined that a vendor is improperly computing tax on its invoices. For example:

- May not be charging tax.
- Charges tax on repair labor or other exempt items.
- Does not charge tax on fabrication labor, trade-ins, or other components of the sale which should be included in the measure of the tax.

• Sales of unauthorized merchandise to Mexican merchants for resale which are discovered during audits of California sellers should be disallowed against the seller. However, a Form BT-1164, identifying the purchaser and describing the merchandise purchased, should be prepared for such sales. The forms should be sent to the San Diego District for its information in monitoring and administering the Mexican merchant program and taking possible action against any merchants who abuse the program (See Section 0409.50)

USE OF AUDIT MEMO ON OUT OF STATE SELLERS (FORM BT-1032) 0408.22

Out-of-State "retailers engaged in business in this State" are required to register and collect use tax on taxable sales made to consumers in this State. A firm is engaged in business in this State even though its sole contact within the State is that orders for its products are solicited by independent brokers, wholesalers or jobbers who are residents of California. (Note: Sales and Use Tax Law, Section 6203, does not apply to sellers whose sales are all for resale.)

Auditors should be alert to recognizing and reporting interstate retail sales by persons who are not collecting the tax. When an auditor discovers that a taxpayer is making untaxed purchases subject to use tax from an out-of-state vendor, the auditor is to advise Out-of-State — Compliance of the vendor using a separate BT-1032 for each out-of-state vendor. The BT-1032's should be forwarded when they are originated and not held until the audit is complete.. If practical, a photocopy of the schedule listing the untaxed purchases should be attached to the notification. If the schedule attached does not include the name and address of the out-of-state retailer, the auditor should make certain that the name and address is shown on Form BT-1032. Without a complete mailing address, it is extremely time consuming and often impossible for Out-of-State — Compliance to properly identify the vendor for correspondence regarding possible registration.

Analysis of purchases from out-of-state retailers may develop information that will lead not only to registration of out-of-state firms, but to the possibility of additional tax liability on the part of those who are registered. Attention should be given to volume purchases of small items as well as to purchases of large items. Reports on sales made to firms in the food processing, entertainment, and service fields merit special attention since these types of business may not be required to hold a seller's permit and use tax due ordinarily would not come to the Board's attention.

Sales made by sellers in contiguous states deserve special attention since their volume of business in California often is extensive.

Information required to effect registration should be completed on Form BT-1032, Information on Out-of-State Retailers (Section **0401.20**). Information required includes:

- a) Name and address of out of state retailer.
- b) Name and address of sales representative.
- c) Name and address of customer.
- d) Invoice number.
- e) Date of invoice.
- f) Amount of invoice.
- g) Description of property sold.
- h) How sale was solicited.
- i) Any other relevant information concerning seller, sales representative, scope of sales, etc.

In completing Form BT-1032, the importance of items (a), (b), (h) and (i) cannot be over emphasized. This information should be obtained, if at all possible, in order to enable Out-of-State - Compliance to determine whether an out-of-state retailer should, in fact, be registered despite a contention made that they were not "engaged in business" in the state.

CALIFORNIA USE TAX COLLECTIONS BY UNREGISTERED OUT-OF-STATE RETAILERS

0408.23

During audits of California taxpayers, it has occasionally been noted that California use tax is being remitted to out-of-state vendors who are not billing the purchasers for the use tax.

Auditors should be alert to these types of transactions and, by utilizing the video, determine whether such out-of-state retailers are registered. When an auditor discovers that a taxpayer is erroneously paying use tax to an unregistered out-of-state vendor, the auditor should immediately advise Out-of-State Compliance. Additionally, the purchaser should be informed of their responsibility for payment of the tax to the proper authority per Regulation 1685.

EXAMINATION OF SELECTED GENERAL LEDGER ACCOUNTS 0408.25

The verification procedure should include an examination of debits in certain general ledger accounts. This is necessary as invoices covering capital expenditures frequently are not filed with the other purchase invoices. From the documentary reference, it is possible to trace the originating documents. Taxable purchases not previously scheduled on which tax was not added by the vendor, should be scheduled and verification made that the taxpayer is responsible for tax. These items are generally located in the following accounts:

Asset Accounts	Expense Accounts
Delivery Equipment	Advertising
Furniture and Fixtures	Donations
Inter-Company Accounts	Expendable Tools
Leasehold Improvements	Experimental and Exploration
Machinery and Equipment	Manufacturing Expense
Non-expendable Tools	Repairs
Work in Progress	Research and Development
	Supplies

This phase of the examination can be done at the same time these accounts are being examined for additional taxable sales.

The auditor should examine invoices representing purchases of significant taxable additions to fixed asset accounts.

Unsupported debits to the fixed asset accounts should be questioned by the auditor and listed on a subsidiary schedule. The taxpayer should be provided with a copy of this schedule and given a reasonable period of time to obtain support for the items in question before closing the audit. If no support is provided use-tax should be asserted against the taxpayer. When necessary a Waiver of Limitation, Form BT–122, should be obtained.

The examination of asset accounts may reveal that the proper amount of use tax has not been paid to the Department of Motor Vehicles on the purchase price of a vehicle. Generally, this occurs in those instances in which (1) the change in ownership was not recorded with the Department of Motor Vehicles; (2) the selling price was substantially different than the measure on which tax was collected by the Department of Motor Vehicles; or (3) the vehicle has special equipment attached which was not included in the measure on which tax was collected by the Department of Motor Vehicles.

In such instances, the use tax is to be asserted against the purchaser.

The measure of additional tax is not to be included in the Form BT–414–E, Report of Field Audit, on the seller, even though disclosed by audit of the seller.

In recommending the additional measure against the purchaser, either Form BT-414-E, Report of Field Audit, or Form BT-414-B, Field Billing Order, will be used, depending on the extent of the examination of the purchaser's records.

Form BT–111, Certificate of Motor Vehicle Use Tax Exemption, will be issued by the district office for those vehicles on which tax is recommended by audit or F.B.O. and the change in ownership was not recorded with the Department of Motor Vehicles.

EXAMINATIONS OF JOURNAL ENTRIES AND REQUISITIONS

0408.30

A retailer may carry a stock of supplies most of which is resold, the balance being self-consumed. All or part of this material may have been purchased for resale. As the supplies are withdrawn from inventory, requisitions may be made by which cost of sales or another expense account is debited and the inventory account is credited.

The auditor should examine these requisitions in the same manner as purchase invoices are examined. If the material was withdrawn from resale (ex-tax) stock and charged to a capital or an expense account, all unreported items not previously scheduled should be listed. If the material was withdrawn from mixed stock, that is tax paid and ex-tax stock, the percentage of ex-tax purchases to total purchases should be computed from a test analysis of purchase invoices. This percentage would then be applied to material charged to taxable accounts.

Commingled fungible goods must be treated differently. In such cases, self-consumed merchandise will be presumed to have been taken from that portion of the stock which was not purchased for resale to the extent such stock is available (See **0408.35**).

It may be found, after a test analysis, that all charges to certain accounts are taxable. In that case, the totals of these accounts can be listed from the general ledger. In other cases, it may be determined that all charges, via requisitions, to certain accounts are taxable but the remaining charges are direct from the purchase journal. Taxable withdrawals from inventory, via requisitions, can generally be located in the general journal.

Taxable withdrawals from inventory may also be made without a record being kept. For example, few bar owners list all drinks consumed or given to customers. Where it is discovered unrecorded withdrawals have been made the auditor should estimate the amount which will have a bearing on tax.

FUNGIBLE GOODS 0408.35

Sales of fungible goods will be considered to have been made from goods purchased for resale until the amount sold equals the amount so purchased. Conversely, merchandise withdrawn from inventory for self-use will be considered to be taken from stocks of goods not purchased for resale to the extent that such stock is available.

The following examples illustrate the application of this principle where commingled fungible goods both purchased for resale and not so purchased are both sold and self-consumed.

		Total Goods	Goods	Goods	Additional
		Acquired	Purchased	Not So	Measure
	_		For Resale	Purchased	of Tax
Example 1	Purchases	\$10,000	\$8,000	\$2,000	
	Resold	_7,000	_7,000	0	
	Subtotal	\$3,000	\$1,000	\$2,000	
	Own Use	1,000		<u>1,000</u>	0
	Ending Inventory	<u>\$2,000</u>	<u>\$1,000</u>	<u>\$1,000</u>	0
Example 2	Purchases	\$10,000	\$8,000	\$2,000	
	Resold	3,000	3,000	0	
	Subtotal	\$7,000	\$5,000	\$2,000	
	Own Use	4,000	2,000	2,000	\$2,000
	Ending Inventory	\$3,000	\$3,000	0 -	

	Total Goods Acquired	Goods Purchased For Resale	Goods Not So Purchased	(Cont.) 0408.35 Additional Measure of Tax
Example 3 Purchases	\$10,000	\$8,000	\$2,000	
Resold	5,000	5,000	0	
Subtotal	\$5,000	\$3,000	\$2,000	
Own Use	_3,000	_1,000	2,000	<u>\$1,000</u>
Ending Inventory	\$2,000	\$2,000	0 -	

USE OR LOAN OF PROPERTY PURCHASED FOR RESALE

0408.40

If a purchaser who timely gives a resale certificate or purchases property for the purpose of reselling it makes any storage or use of the property other than retention, demonstration or display while holding it for sale in the regular course of business, the storage or use measured by the purchase price is taxable as of the time the property is first so stored or used. However, Sections 6094 and 6244 provide that for property used under the following conditions the measure of the tax is the fair rental value of the property for the period of such other use:

- Loan of property to customers as an accommodation while awaiting delivery of property purchased or leased from the lender, or the loan of property to a customer while the customer's property is being repaired by the lender.
 - If a specific charge is made for use of the property, this may be used as the measure of tax provided the charge is consistent with the fair rental value.
- Property used frequently for purposes of demonstration or display and used partly for other purposes.

Property loaned to customers or used by the taxpayer may not be recorded or merely recorded as memorandum entries. The above types of transactions may be disclosed through a discussion with the taxpayer, their employees, or by examining sale invoices or rental agreements.

AUDIT OF SALES FOR RESALE

0409.00

GENERAL 0409.05

Sales for resale is the most common deduction claimed and the auditor should be familiar with all of the methods used by taxpayers in compiling the amounts reported and the various auditing procedures used to verify those amounts. Whenever feasible, the audit procedure should be adapted to the method used by the taxpayer in reporting, as this makes it easier to reconcile audit findings with reported figures, and usually reduces auditing time. Examination of taxpayer's working papers and a conference with the taxpayer will disclose the method used.

METHODS OF REPORTING RESALES

0409.10

The most common methods used by retailers in compiling data for the claimed sales for resale deduction are:

- To prepare an actual list of deductible items.
- To calculate the deduction as described in (0409.20).
- To estimate the deduction.

DEDUCTION SUPPORTED BY ACTUAL LISTS

0409.15

The deduction is supported by lists of nontaxable items which may be prepared in one of the following methods:

- By scheduling each nontaxed invoice.
- By recording sales for resale in a separate column in the sales journal.
- By preparing adding machine tapes of sales for resale invoices.
- By recording sales for resale in the general ledger, and supporting the amounts by journal entries.

DEDUCTION CALCULATED

0409.20

One method frequently used by taxpayers in computing a sales for resale deduction is to determine the residual amount after deducting the sum of taxable sales and other deductions from total sales. In determining this residual amount, the taxpayer may:

- List the total taxable sales and exempt sales other than sales for resale if they are few in number.
- Convert to measure of tax the amount of sales tax reimbursement as recorded in the sales tax accrual
 account. If no reserve account is maintained, the sales tax collected is usually compiled by running
 adding machine tapes of the sales tax charged on all sales invoices.

The formula used in this conversion of tax is, of course, tax collected divided by rate of tax (Tax / Rate = Taxable Sales).

DEDUCTION ESTIMATED

0409.28

Where the taxpayer estimates the deduction, there will be no support for the amounts claimed, nor will the basis for the estimate lend itself to ready verification. In these instances, the auditor should use one of the verification procedures outlined below which seems best suited to compile the deduction with a minimum expenditure of audit time.

SELECTION OF THE BASIS FOR THE AUDIT

0409.30

The extent of audit of sales for resale will depend on the conditions encountered. If the claimed deduction consists of relatively few items so that all transactions can be examined in a reasonable amount of time, the audit should be made in detail. This is particularly true where the unit sale is in a large amount or where the amount of the average unit sale is small with an occasional large sale. If, however, sales for resale are numerous and of a reasonably similar unit value, the verification can and should be made on a test basis. The size of the test will depend on the number of documents necessary to examine.

The periods or number of transactions selected should be representative of the business as a whole. Whenever possible the test should be selected using a statistical sample. Whether a statistical sample or block sample is selected, a control of sales for the transactions being tested must be established.

In audits of unusually large concerns with relatively few retail sales or audits of concerns using computerized accounting, special procedures may have to be adopted. Because each of these cases presents its own special problems, possible audit methods for such cases are not discussed in this chapter.

The audit procedures used to verify sales for resale may be roughly classified as follows:

- Detailed audit lists of claimed sales for resale available.
- Detailed audit lists of claimed sales for resale not available.
- Audit on test basis (see Section **0405.20**).

DETAILED AUDIT — LIST OF CLAIMED RESALES AVAILABLE

0409.35

Claimed resales should be summarized by months or by quarters in accordance with the taxpayer's listings. The taxpayer's detailed schedules will be used as a basis for the verification. The steps necessary to making the verification are:

- a) The sales invoices should be examined to determine that the claimed amounts are included in total sales and that the correct amounts have been scheduled. It should be verified that the amounts claimed do not include nontaxable items (delivery charges, labor, etc.) claimed under some other classification, and that no part of the invoice represents a taxable sale.
- b) Documentary evidence of the nontaxability of the sales, such as resale certificates, purchase orders, correspondence, or contracts should be examined. Purchase order, correspondence or contracts may, also, support a finding that a claimed sale for resale is taxable notwithstanding the fact that a resale certificate is on file (Section **0409.50**).
- c) The nature of transactions and the type and number of items purchased should be scrutinized to determine whether resale certificates (Section **0409.55**) appear to have been taken in good faith.

All sales which are questioned for any reason should be listed on a subsidiary schedule. A copy of this schedule should be given to the taxpayer as an aid in attempting to support the exempt status of the questioned items. A reasonable period of time should be given the taxpayer to obtain this information before closing the audit. When necessary a Waiver of Limitation, Form BT–122, should be obtained.

DETAILED AUDIT — LIST OF CLAIMED RESALES NOT AVAILABLE 0409.40

The taxpayer should be requested to prepare a detailed listing of all sales for resale claimed, being allowed a reasonable amount of time to do so. When his work has been completed, the audit procedure will be the same as set forth in Section **0409.35**.

EFFECT OF "CONTRA" ITEMS ON DEDUCTIONS FOR SALES FOR RESALE

0409.45

Contra items as they relate to the deduction for sales for resale are:

- Sales for resale omitted from total sales and from the claimed sales for resale.
- Sales for resale claimed under the heading of some other deduction, such as labor, etc.
- Sales of labor, sales in interstate commerce, etc., claimed under the heading of sales for resale.

When the audit of all deductions is made on a complete basis or when the audit is made on a taxable sales basis, the final result will not be affected if the deduction is allowed to remain in the classification under which it was reported. If the audit is made on a test basis with all deductions being audited, it will sometimes be necessary to reclassify deductions under their proper heading to establish a proper base for computation and application of a factor of error.

ACCEPTABLE DOCUMENTARY EVIDENCE TO SUPPORT SALES FOR RESALE

0409.50

A claimed sale for resale should be allowed if it is supported by a resale certificate that is proper in form and is timely taken in good faith from a person who is engaged in the business of selling tangible personal property and who holds a California seller's permit. A certificate will be considered timely if it is taken at any time before the seller bills the purchaser for the property, or any time within the seller's normal billing and payment cycle, or any time at or prior to delivery of the property to the purchaser.

Sales to Mexican Merchants for resale are allowable if the requirements outlined in Tax Tip Pamphlet 32 are met. The auditor should insure that the purchaser was the person named on the Mexican Merchant identification card, that the card was valid at the time of the sale (cards have expiration dates), and that the merchandise purchased for resale related to the special business classification codes in the pamphlet. Assistance in verifying Mexican merchants registered under the program and the type of property they are authorized to purchase for resale can be obtained by calling the San Diego District. Additional information about the program is contained in Tax Tip Pamphlet No 32.

Any document, such as a letter or purchase order, timely provided by the purchaser to the seller will be regarded as a resale certificate with respect to the sale of the property described in the document if it contains all of the essential elements in Regulation 1668. A resale certificate which has been sent via a facsimile machine (faxed) is acceptable provided that it contains all of the required information, is timely, and is accepted in good faith.

Other evidence of the validity of a claimed sale for resale may be accepted, such as:

- A notation on a purchase order where a qualified blanket resale certificate is on file.
- A purchase order taken where all the elements of a valid resale certificate are shown therein.
- A letter covering a specific purchase from an out-of-state retailer or from a California purchaser if all the elements of a resale certificate are shown therein.
- Contracts of sale where all the necessary information is shown. The auditor should be especially careful to scrutinize transactions where the purchaser claims to be reselling to the U.S. Government, to determine that the merchandise is actually being resold in the form of personal property and that title is passed to the Government prior to any use by the purchaser and that it is not for use in making improvements to real property.
- Personal knowledge of the auditor gained from audits of the vendees or other sources that the purchase was actually made for resale purposes.
- A satisfactory response to a Form BT-504 (XYZ letter) inquiry (See Section 0405.20(j) and Exhibit 6).

The auditor must insure that the taxpayer understands that any of the above evidence by itself is not the equivalent of a resale certificate timely taken in good faith, and may not relieve the seller of the liability for the tax.

USE OF BT-504 — XYZ LETTER PROCEDURE

0409.51

PARAGRAPH TO BE PUBLISHED SEPARATELY AT A LATER DATE.

WHEN GOOD FAITH OF SELLER IS QUESTIONED

0409.55

A resale certificate relieves the seller from liability for sales tax and the duty of collecting the use tax if the seller timely takes a certificate in good faith from a person who is engaged in the business of selling tangible personal property and who holds a California seller's permit.

A seller will be presumed to have taken a resale certificate in good faith in the absence of evidence to the contrary. If the purchaser insists that property of a kind not normally resold in their business is being purchased for resale, the seller should require a resale certificate containing a statement that the specific property is being purchased for resale in the regular course of business. If the good faith of the seller is in question, the burden of proof will rest with the Board.

The auditor has the responsibility of examining the resale certificates. The auditor must be reasonable and fair-minded and must use good judgment in determining whether the certificate is sufficient in content and whether the seller acted in good faith in accepting the certificate.

Examining the resale certificates, which give general descriptions of the purchaser's business, and invoices of sales for resale, which disclose the type of property sold, requires the auditor to judge whether items shown on the invoices are properly included within the general description.

In making a decision, the auditor should be guided by the test of reasonableness. The auditor should question sales for resale that do not meet such a test or if the seller knows beyond a reasonable doubt that the property was bought for the purchaser's own use. Examples of transactions which should be questioned include:

- Sale of furniture or fixtures to a grocery.
- Sale of janitorial supplies to a restaurant.
- Sale of building materials to a contractor where the terms of sale specify delivery to the job site.
- Sale of cleaning solvent to a repairman.
- Tools sold by a parts house to a repair shop.

When the seller insists a particular item, not reasonably included in the description, was actually sold for resale, the seller should be required to secure a statement from the purchaser covering the specific item in question.

PURCHASE ORDERS AND RESALE CERTIFICATES

0409.60

A resale certificate may be qualified by specific instructions on the purchase order. A purchaser who issued a blanket resale certificate to a supplier may specify on a purchase order that the property to be purchased is taxable. Purchase order files should be examined when doubtful situations arise. However, under such circumstances the purchaser will bear the burden of establishing either that the purchase order was received by the seller or that the tax was paid to the seller.

The seller should obtain a resale certificate qualified by special instructions, i.e., one that states "see purchase order", when a purchaser wishes to designate on each purchase order that the property is for resale. Each purchase order must specify whether the property covered by the order is purchased for resale or whether tax applies to the order.

MISUSE OF RESALE CERTIFICATE

0409.62

When resales are examined during the course of an audit, particular attention should be paid to transactions that may involve a misuse of a resale certificate. A misuse occurs when the purchaser is not actively engaged in business as a seller or the purchaser knows at the time of purchase that the property is not going to be resold in the regular course of business. Specific situations that indicate the purchaser has made a misuse are when:

- The purchaser, who does not hold a sellers permit, issues a resale certificate with an erroneous seller's permit number or gives the valid number of a permit held by another person, or
- the purchaser's permit was closed out prior to the date of purchase, or

0409.65

• the purchase, regardless of amount, is one of a series of purchases which were not intended to be resold by the purchaser in the regular course of business.

When a misuse occurs, the purchaser will be pursued for the tax and appropriate penalty (Chapter 5).

A resale certificate which was taken timely and appears to be valid on its face will relieve the seller of the tax liability if the certificate is taken in good faith. For audit purposes "valid on its face" means that the resale certificate contains the five essential elements described in Regulation 1668, even if one or more of the elements are false. If, however, it is found that the seller makes a practice of accepting defective resale certificates, the sellers good faith is in doubt. In this case, tax should be asserted against the seller. Questioned sales for resale which represent defective certificates accepted in good faith should be excluded from the sample and the computation of the percentage of error.

TAX BILLED BY VENDOR BUT DELETED BY PURCHASER

If the seller does not timely obtain a resale certificate, the fact that the purchaser deletes the tax or tax reimbursement from the seller's billing, provides his/her seller's permit number to the seller, or informs the seller that the transaction is "not taxable" does not relieve the seller from liability for the tax nor from the burden of proving the sale was for resale.

VERIFICATION OF PAYMENT OF USE TAX BY PURCHASER 0409.70

At the time of an audit of a vendor, the vendor may contend that a purchaser-consumer has paid tax on a transaction on which the vendor failed to collect use tax. In these cases, the vendor should be given an opportunity to establish that tax was paid by obtaining a statement from the purchaser that:

- Use tax was declared on a specific return filed by the purchaser, or
- Use tax was paid as a result of a determination made after audit by the Board. In making this statement, the purchaser must establish that the specific item was included in the audit or that the item was of the kind and monetary size included in a percentage of error applied throughout the audit period.

See Section 0405.20 (j) when XYZ letter inquiries are involved in audit test sample(s).

AUDIT OF SALES TO THE U.S. GOVERNMENT

0410.00

GENERAL 0410.05

The details covering sales to the United States Government are contained in Regulations 1521, 1614, and 1618. These regulations may be summarized as follows:

- a) Sales tax does not apply to sales to:
 - The United States or its unincorporated agencies and instrumentalities.
 - Any incorporated agency or instrumentality of the United States wholly owned by either the United States, or by a corporation wholly owned by the United States.
 - The American National Red Cross, its chapters and branches.
 - Incorporated federal instrumentalities not wholly owned by the United States, unless federal
 law permits taxing the instrumentality. Examples of incorporated federal instrumentalities exempt
 from tax are federal reserve banks, federal credit unions, federal land banks, and federal home
 loan banks.
- b) Use tax does not apply to the storage, use, or other consumption of tangible personal property by agencies or instrumentalities of the United States unless federal law permits taxing the agency or instrumentality.
- c) Neither sales nor use tax applies to sales of machinery and equipment to United States construction contractors or subcontractors, provided title to the property passes to the United States before the contractor makes any use of it. Such sales are sales for resale, and the purchasing contractor may issue a resale certificate. A contractor who uses the machinery or equipment before title passes to the United States is the consumer of property, and either sales tax or use tax applies with respect to the sale to or the use by the contractor. The application of tax to consumable supplies and overhead materials on United States Government Supply Contracts (Regulation 1618) is covered in Section 0411.
- d) Generally, either the sales tax or the use tax applies with respect to sales of tangible personal property (including materials, fixtures, supplies, and equipment used to perform the construction contract) to United States construction contractors for use in the performance of such contracts for the construction of improvements on or to real property in this state (Regulation 1521).

AUDITING PROCEDURE

0410.10

An audit of this deduction should be made in the same manner as an audit of a deduction for sales for resale. Ordinarily the number of such sales is limited and the audit should be made on a complete basis. If, however, the number of items claimed is exceptionally large and the average unit of sale is comparatively small, a test basis may be used. Documentary evidence required to support the deduction, where the sale is made directly to the United States Government, a subdivision or agent, should consist of one or more of the following documents:

- Purchase orders.
- Remittance advices.
- Shipping and other documents if there is a question whether the merchandise was sold directly to an individual who is in the armed services.

Sales to contractors who are engaged in work on projects owned by the United States Government are not sales to the Government. If the contractor is actually selling tangible personal property to the Government such sales are sales for resale and should be verified as such. Mention is made of this in this section only because many retailers classify such sales as sales to the United States Government and erroneously claim the deduction under that heading rather than sales for resale. If the auditor has reason to believe the material purchased was not actually sold by the contractor-customer to the U.S. Government, an audit memorandum (0401.20) should be prepared setting forth all pertinent phases of the transaction.

SALES TO FEDERAL EMPLOYEES USING U.S. GOVERNMENT BANKCARDS

0410.15

Civilian and military employees are authorized to make purchases for official use by using a U.S. Government Bankcard called an "International Merchant Purchase Authorization Card" or "I.M.P.A.C." The cards are identical to regular bankcards, and bear the VISA trademark. The General Services Administration administers the program for all departments and agencies of the U.S. Government. Sales made to a federal employee using an "I.M.P.A.C." will generally qualify as exempt sales to the U.S. Government.

Use of U.S. Government Bankcards is generally restricted to single purchases of less than \$25,000 and will not be accepted for purchases from certain types of merchants or for travel related expenses. Competitive bids will normally be required for purchases over \$1000. Authorization for purchases will automatically be denied on transactions with the following merchant types:

Airlines Trains Buses Boats

Travel agencies Auto rental agencies Hotels/Motels Restaurants/Bars

U.S. Government Bankcards replaced the Federal Standard Form 44 (field purchase order) that had been used as an "across the counter" purchase document for stocked items. In general, a valid Bankcard receipt and retailer invoice will be adequate supporting documentation for sales and use tax purposes. A separate purchase order or government remittance advice will not be required. However, for sales exceeding \$1000, government documents indicating awarding of the contract through competition should also be available.

Bankcard receipts for valid sales to the U.S. Government should contain the imprinted words, "U.S. Govt. Tax Exempt," and an account number beginning with the number sequence 4716. When verifying U.S. Government Bankcard transactions, these imprints must be noted in addition to the previously mentioned transaction limitations.

Transactions not supported by this minimum information or exceeding the single purchase limit should be disallowed. In addition, should an auditor encounter Bankcard transactions with unauthorized merchant types, the sales in question should be questioned and subsequently disallowed if not supported by the retailer.

In addition to the I.M.P.A.C. Visa bankcard, the U.S. Government has contracted with American Express to supply American Express credit cards for federal travel-related purposes (transportation, food, and lodging expenses). The cards have the employees name and possibly the agency name below it. The card will usually state "UNITED STATES GOVERNMENT" beneath the AMEX logo. All U.S. Govt. cards have a four digit prefix of "3783" as part of the fifteen digit account number. Sales made on cards which are billed directly to the employees (card has a 7 or 8 as the fifth digit) **are not exempt** as the sale is to the employee. Sales made on AMEX cards which are centrally billed (fifth digit is 9) **are exempt** as sales to the U.S. Govt.

UNITED STATES GOVERNMENT SUPPLY CONTRACTS

0411.00

SECTION TO BE PUBLISHED SEPARATELY AT A LATER DATE

GENERAL 0412.05

There are several methods of compiling a deduction for cash discounts depending primarily upon the accounting methods in use and the sales policy of the taxpayer. As the deduction is limited to cash discounts actually taken on taxable sales, the problem is to separate the discounts taken on taxable sales from those taken on nontaxable sales. The verification should be made only after total sales and other deductions have been verified, as any change made by the auditor in the taxpayer's classification of taxable and nontaxable sales will affect the deduction for cash discounts. Methods of reporting may be summarized as follows:

- Actual discounts taken on taxable sales.
- Percentage of total discounts taken based on ratio of taxable sales to total sales.
- Composite percentage of taxable sales.
- Cost of trading stamps issued on taxable sales.

ACTUAL CASH DISCOUNTS TAKEN ON TAXABLE SALES

0412.10

The taxpayer's working papers should be examined to determine how the deduction was compiled. If an actual listing of the sales invoices on which the discounts were allowed is available, the auditor can verify the deduction in detail by reference to the sales invoices and the cash receipts record. Usually the sales are too numerous for listing and the cash discounts are summarized by months from the "cash discounts" column in the cash receipts records. In those cases the audit should be based on a test period. If other deductions were verified on a test basis, the same periods should be used in whole or in part to test this deduction. This will obviate further work in verifying the exempt status of additional transactions outside the test periods used in verifying the other deductions. Each cash discount shown by the cash receipts records should be compared with the sales invoice to which it pertains. Auditors should satisfy themselves that each discount allowed passes the following tests:

- That the discount was actually taken by the purchaser.
- That the difference between the invoice price and cash received is actually a cash discount.
- That the discount applies to a taxable sale.
- That the cost of trading stamps has been reduced by any "dividends" or rebates received from the stamp company based on purchases of stamps.
- That the discount was computed so as to reduce the amount of sales tax reimbursement initially charged the customer on the gross taxable sales.

When there is no indication that the discount was computed on the selling price exclusive of sales tax reimbursement, it will be considered that the discount was allowed on the total sales price including sales tax reimbursement. This is usually the case with unit or lump-sum discounts. When there is evidence that the discount was computed by applying a percentage to the selling price exclusive of sales tax reimbursement, the discount will not be allowed as a deduction since excess tax reimbursement has been retained by the retailer.

If a taxpayer has not claimed a deduction for cash discounts, credit or refund should be recommended in an audit only if the taxpayer refunds to the customer any excess tax reimbursement which results from the method of computing the cash discount.

COMPOSITE PERCENTAGE OF DEDUCTIONS TAKEN

0412.15

Some companies allow cash discounts on different bases to various classes of customers. For instance, the discount rate may be based on sales volume or on different types of merchandise sold. Under these conditions, a composite percentage can be computed and used. A representative test period should be selected and the taxpayer be requested to analyze all cash discounts taken on taxable sales by scheduling the discounts allowed and the related taxable sales for the period. The percentage will then be computed in accordance with the following example:

Total discounts allowed on taxable sales	\$1,560
Total taxable sales on which discounts apply	\$100,000
Average discount rate (\$1,560/\$100,000) or	1.56%

This rate can then be applied to quarterly taxable sales (excluding purchases subject to use tax) for the entire audit period.

PERCENTAGE OF TOTAL DISCOUNTS TAKEN

0412.20

Theoretically, if all customers took the cash discount allowed and if the same rate of discount were applicable to all sales, the cash discount deduction could be computed by determining the ratio that taxable sales bore to total sales (excluding purchases subject to use tax) applied to total discounts allowed. This may be expressed as follows:

Allowable Discounts =
$$\frac{\text{Taxable Sales}}{\text{Total Sales} + \text{Tax}} \times \text{Discounts Taken}$$

However, in many instances it will be found that a large proportion of the discounts are taken by large purchasers who buy for resale. Thus, the use of the above formula would produce an inaccurate result. In these cases, the auditor should determine the ratio that discounts taken on taxable sales bear to total discounts taken for one or two test periods. This percentage would then be applied to total discounts taken each quarter of the audit period:

$$Allowable\ Discounts = \frac{Discounts\ Taken\ on\ Taxable\ Sales\ -\ Tax}{Total\ Discounts\ Taken} \times Discounts\ Taken$$

The total discounts taken can be transcribed from the general ledger account after the auditor has satisfied himself/herself the account represents discounts allowed only and does not include any bad debts on nondeductible items.

TRADING STAMPS 0412.25

The cost of trading stamps may be taken as a deduction in the same manner as cash discounts if the taxpayer complies with either of the procedures which follow:

- Adjust the price on which tax reimbursement is computed so it will correspond to the price upon which the retailer computes the tax paid by him to the State.
 - For example, a retailer makes a sale for \$100 plus \$6 tax reimbursement, gives trading stamps which cost \$3 on the ex-tax selling price of \$100 and takes a deduction of \$3 as a cash discount. He reports sales of \$97 and pays \$5.82 (6% of \$97). Collection of excessive sales tax reimbursement of 18 cents resulted from the transaction. The taxpayer should have reported sales of \$100 since tax reimbursement was collected on that amount.
- Consider the price which determines the number of stamps to be given a customer as the total amount (including sales tax) paid by the customer.
 - For example, if one stamp is given for each 10 cents of purchase price and the total purchase price is \$10.60 (\$10.00 plus \$.60 sales tax), give 106 stamps to the customer rather than 100.

From time to time retailers introduce various promotional plans, some of which may qualify as allowable cash discounts. Such plans must be individually analyzed to determine their status for sales tax purposes.

SALES TAX INCLUDED IN CASH DISCOUNTS

0412.35

If the cash discount taken by the purchaser is allowed on both taxable and nontaxable items (sales tax, labor, cartage, etc.), the latter items must be eliminated before computing the deduction. In most instances, this nontaxable element will be limited to sales tax and may be excluded after the gross discount has been computed. This can be accomplished by multiplying the discount by a factor which will reduce the gross discount to the allowable discount. The factor is derived using the following formula:

$$Factor = \frac{1.00}{1 + Tax Rate}$$

For example, if tax has been included in the discounts at the rate of 8.25%, then the factor will be .9238, computed as follows:

Factor = $\frac{1.00}{1 + .0825}$ = .92377876

AUDIT OF RETURNED MERCHANDISE

0413.00

GENERAL 0413.05

A deduction for returned merchandise must meet the requirements of Regulation 1655. Actual returns of taxable sales are deductible if the following conditions are met:

- The original sale is included in reported taxable sales.
- The full sales price, including sales tax, is refunded either in cash or credit. For purposes of the returned merchandise deduction, "full sales price" is construed to include only amounts required to be included in the measure of tax under Sections 6011 and 6012, plus any sales tax added. For example, transportation charges not subject to sales tax need not be refunded in order to claim the returned merchandise deduction (Section 0413,25).
- The customer in order to obtain the refund or credit is not required to purchase other property at a price greater than the amount charged for the property returned.

Refund or credit of the entire amount is deemed to be given when the purchase price and sales tax, less rehandling and restocking costs, if any, are refunded or credited to the customer (Section **0413.25**).

Credit for returned merchandise cannot be allowed if the retailer sets up a credit in the books but fails to give written notification to the customer that the credit is available.

METHODS OF CLAIMING THE DEDUCTION

0413.10

Merchandise returns are generally entered in the taxpayer's books in one of the following ways:

- As debits to an account in the general ledger, and claimed as a deduction on the sales tax return. The deduction, when handled in this manner, should be audited in the same way as any other deduction.
- As debit entries in the sales journal (therefore, a reduction in sales) with no deduction being shown on
 the sales tax returns. When this procedure is followed the verification of the deduction should be made
 in conjunction with the audit of total sales.

AUDITING PROCEDURE — DEDUCTION CLAIMED

0413.15

The original documents covering returned merchandise usually consist of credit memoranda which, together with the original sales invoices, are the basis of the credit. Occasionally, an auditor will encounter a situation where no credit memoranda are issued, the taxpayer merely marking on the original invoices or in the sales journal the words "canceled" or "returned". Such returns or cancellations should not be allowed unless the taxpayer can furnish documentary evidence of returns actually made and meeting the conditions listed in **0413.05**. All nontaxable elements of the sale must be eliminated. The claimed deduction can be audited on a complete basis or a test basis, depending on the frequency of returns and the amounts involved.

AUDITING PROCEDURE — DEDUCTION NETTED FROM SALES 0413.20

When returned merchandise is "netted" from total sales (0413.10), a separate verification of the returns cannot be made as there is no control of the recorded or netted amounts. The verification must therefore be combined with the examination of total sales, all credit memoranda being examined at the time the sales tickets are examined. All netted items not meeting the requirements listed in 0413.05 are to be treated as additional taxable sales not reported and may be combined with unreported or unrecorded sales as a basis for computing an understatement of taxable sales.

There are two methods of compiling the cost of rehandling and restocking returned merchandise. The retailer may use:

- a) The actual cost of rehandling and restocking the returned merchandise. The cost may include, but is not limited to the retailer's direct costs of the following:
 - Inspection of the merchandise after the request has been made for its return
 - Issuance of authorization for return of the merchandise after the request has been made for its return
 - Freight or delivery charge for shipment of the merchandise from the customer to the retailer
 - · Returning the merchandise to stock, and
 - Direct "paper work" involved in the return of merchandise such as preparation of credit memos, accounts receivable corrections, inventory record adjustments, etc., to the extent that it is possible to determine these costs.
- b) A percentage of the sales price based on the average cost of rehandling and restocking returned merchandise.

The percentage must be based on the average of the actual costs of rehandling and restocking the returned merchandise for the entire previously completed accounting cycle (normally one year). The percentage is computed by dividing the total <u>allowable</u> rehandling and restocking costs incurred in the previous accounting cycle by the total sales price (excluding sales tax) of the merchandise returned during that period. Retailer's choosing the percentage of sales method may not:

- Use industry wide averages
- Use actual cost during any accounting cycle in which an election was made to use the percentage method.

Regardless of which of the two methods is used, only the actual cost of rehandling and restocking returned merchandise is allowable. The taxpayer must maintain adequate records to support how the charge for restocking and rehandling was determined. If the taxpayer incorrectly computes the percentage and accordingly charges a greater, incorrect restocking charge for the entire subsequent year, only those transactions where the actual restocking costs on any specific transaction are equal to or greater than the erroneous percentage claimed, may be allowed.

Delivery charges and other charges that are subject to tax as a part of the "gross receipts" must be included in the total sales price when computing the applicable percentage for rehandling and restocking. The computed percentage is applied to the total sales price (excluding sales tax) of merchandise subsequently returned to arrive at the allowable rehandling and restocking charges for sales and use tax purposes. The refund or credit should be computed in the following manner:

Price of merchandise returned	\$100.00
Sales tax @ 8.25%	<u>\$8.25</u>
Total	\$108.25
Restocking and rehandling charge @ 10% (\$100 x .10)	\$10.00
Amount refunded or credited	_\$98.25

RETURN OF TAX REIMBURSEMENT

0413.26

If the retailer separately computes the sales tax refund or credit at an amount less than the sales tax on the original transaction, the difference between the sales tax collected and the sales tax refunded is regarded as excess tax reimbursement and should be handled in accordance with Section **0417.00**.

EXAMINATION OF ACCOUNTS RECEIVABLE

0413.30

The auditor should examine a sufficient number of individual customers' accounts to satisfy themselves that the credit memoranda on file actually represent bona fide credits of the original sales price plus tax. Some retailers issue a credit memo in full but make a service charge or some charge other than a restocking or rehandling charge to the customer. If this condition is discovered, the auditor should disallow the deduction.

It will be noted that Regulation 1655 states in part" ...the full sales price, ... is refunded in cash or credit ..."

Where the retailer has issued a credit memo and notified the customer in writing at the last known address that a bona fide credit for the full sales price including sales tax is available and the customer's account is so credited, the deduction is allowable. This will be true even though the customer does not utilize the credit and after a reasonable period of time the retailer transfers the unused credit to miscellaneous income or some other income account.

DEFECTIVE MERCHANDISE

0413.35

When defective merchandise is returned to the seller, under conditions not meeting the requirements of Regulation 1655 (0413.05), a deduction may be taken only for the amount credited or refunded because of the defective condition of the merchandise. No deduction can be allowed for the amount refunded or credited because of the return of the merchandise. Accordingly, where the returned defective merchandise has some value, the amount refunded or credited to the customer must be reduced by the value of the merchandise in its defective condition.

PRICE ADJUSTMENTS

0413.40

Occasionally, the auditor will encounter situations where amounts claimed as returned merchandise represent price adjustments on merchandise actually retained by the customer. For example, a customer is not entirely satisfied with the merchandise and wishes to return it. The seller, not wanting to restock the merchandise will prevail upon the customer to keep the merchandise at a reduced price. The price adjustment is then refunded or credited to the customer. Such price adjustments will be deductible if the customer is actually given a refund in cash or a credit in an amount equal to the agreed upon adjustment, plus sales tax on that amount.

AUDITS OF SALES IN INTERSTATE OR FOREIGN COMMERCE

0414.00

GENERAL 0414.05

Regulation 1620 describes the transactions which are exempt from sales tax when shipment is made in interstate or foreign commerce. It also sets forth the conditions which determine whether merchandise shipped into this state is subject to sales tax or use tax.

AUDITING PROCEDURE — SHIPMENTS OUT-OF-STATE

0414.10

The general auditing procedure for sales for resale applies to this deduction. The audit may be made on either a complete basis or a test basis depending on the number and dollar value of the transactions. Examples of documentary evidence to support a deduction as a sale in interstate or foreign commerce are:

- a) Delivery by facilities operated by the retailer
 - Correspondence
 - Delivery receipts
 - Expense vouchers supporting delivery expense
- b) Shipment by carrier
 - Freight

Bills of lading

Freight invoices

Express

Express receipts

Express company invoices

Parcel post

Parcel post receipts

Record of parcel post shipments

In many instances the sales invoice will show parcel post charges and shipping instructions

- c) Delivery by retailer to customs broker or forwarding agent
 - · Bills of lading
 - Copies of import documents of foreign country
 - Notation on invoice
 - Invoices for services of customs broker or forwarding agent
 - Delivery receipts
- d) Delivery to a steamship or other conveyance furnished by a foreign purchaser for shipment to a foreign destination.
 - · Bills of lading
 - Import documents of a foreign country or other documentary evidence of export must be obtained and retained by retailers to support deductions taken.

In addition to the above, it often is possible to support the exempt status of the shipment by examining purchase orders which generally contain the shipping instructions.

The auditor should note that the following transactions are *nondeductible*:

- If delivery is made in California to the purchaser or the purchaser's agent, except as permitted in (c) and (d) above.
- If the sale is made to the purchasing carrier which transports the property to an out-of-state point in the capacity of a purchaser rather than as a common carrier, i.e., the property is not shipped under a commercial bill of lading.

AUDIT PROCEDURE — SHIPMENTS INTO THE STATE

0414.15

Property purchased out-of-state for consumption in California is ordinarily subject to the use tax. In some cases it is important that the auditor determine whether sales or use tax is applicable to personalty shipped from a point outside this State to a point inside the State. Examples of documents used to make this determination are:

- Purchase orders
- Sales contracts
- Sales invoices
- Bills of lading
- Freight bills
- Correspondence

In examining the above documents to determine the applicable tax, the auditor should bear in mind that if title to the property (or possession under a conditional sales contract) passes to the purchaser outside this State, the use tax is applicable.

Property purchased by insurance companies for their own consumption is exempt from use tax.

AUDIT OF DEDUCTION FOR LABOR

0415.00

GENERAL 0415.05

Labor charges to customers may be classified in two categories:

- a) Exempt
 - Installation
 - Repair or reconditioning
- b) Taxable
 - Fabrication
 - Assembly

The principal problem involved in auditing the deduction is that of segregating installation and repair labor from fabrication labor and the fair retail price of the merchandise used in repairing or reconditioning property. This problem has been overcome to some extent by authorizing certain classes of businesses, who make lump-sum charges for repairing, to claim as a labor deduction a fixed percentage of the total charges to the customer. Examples of this type of repair are motor rewinding, restringing tennis rackets, etc. In auditing this type of deduction, the auditor should verify total repair sales and apply the authorized percentage.

AUDITING PROCEDURE

0415.10

Unusual labor charges claimed as deductions should, of course, be examined in detail. However, the deduction for labor usually consists of a great many items so that the audit generally will be made on a test basis such as described under Audit of Sales for Resale. Sales invoices, together with repair orders, cost sheet and other original documents should be secured for the test period. The total labor claimed during the period tested should be reconciled with the amounts shown by detailed invoices. Differences should be scheduled and a percentage of error computed.

The general rule is that installation and repair labor charges are exempt if segregated in the taxpayer's records. Generally, the segregation is shown on sales invoices, but the deduction should be allowed even though it is not shown on the invoice if either:

- Sales tax has been charged on a portion of the total sales from which the selling price of the material can be computed, or
- The charge for labor is segregated in the sales journal, cost sheets, estimate sheets or repair orders.

The segregation should be questioned if material is billed at cost or less with all profit on the transaction allocated to labor. If the retailer does not make a segregation, the retail selling price of the parts and materials will be determined based on information available. In general, the material should be priced at the fair retail value, but if the retail price is not known, the mark-up realized on an entire job should be prorated according to material and labor costs.

Among the problems which may arise in verification of labor deductions are:

- a) Some repair jobs actually involve both repair and fabrication labor. For example a repairman may, of necessity, fabricate certain parts used in the repair.
- b) Some remodeling jobs may be either repair or fabrication labor, depending upon the end product. For example, labor charges for rebinding a rug are classified as repair. However, labor charges for cutting a rug into two or more pieces and rebinding the pieces so that the customer receives two or more rugs is classified as fabrication labor.
- c) Audit of labor deductions claimed by construction contractors frequently involves complex problems. Many of these require differentiation between fabrication and installation labor. Others necessitate determining whether the contractor is the consumer or the retailer of the property furnished.
 - A contractor may fabricate and install a fixture. The fabrication labor must be segregated from the installation labor to properly determine the tax liability.
 - A construction contractor, when billing a time-and-material contract, may add tax reimbursement on a marked up price of materials. The amount billed and not the cost should be considered the selling price of the materials.

As many labor operations are borderline, the auditor should make a clear, concise statement of the reason for disallowing each item or category of items; i.e., a machine shop may make a labor charge described as "repairing customer's pipe". An examination of the job record indicates the pipe was "cut into designated lengths and threaded." This brief description indicates fabrication labor, not repair labor, as claimed.

AUDIT OF SALES TAX INCLUDED IN SALES

0416.00

GENERAL 0416.05

Some retailers, when accounting for total sales, record only the sales price of the merchandise in the sales account and credit sales tax reimbursement to a reserve account. This procedure contemplates a separation of the sales price from the sales tax on either sales tickets or cash register readings. In any event, sales tax collected is not included in reported gross sales.

Other retail establishments such as markets, taverns, and restaurants often find that separation of the sales price from tax reimbursement is not practical and the entire amount charged the customer is credited to sales. In the latter cases, the taxpayer is entitled to a deduction for sales tax included in total sales provided it can be proved to the satisfaction of the board that they have not absorbed the tax but have actually taken it into consideration in determining the total sales price of the merchandise.

AUDITING PROCEDURE

0416.10

In cases where a sales tax accrual account is maintained, the clerical accuracy and propriety of the amounts posted to that account should be verified. A sales tax accrual account showing credits only slightly in excess of taxes paid, or payments in excess of collections, does not necessarily indicate errors in reporting.

In reconciling the accrual account, the auditor should adjust for tax on the measure of cash discounts, bad debts claimed, refunds of tax to customers who were charged in error and for any other instances where the taxpayer did not debit the accrual account where such a charge was in order. In addition, the auditor should adjust for such items as reported self-consumed merchandise and any other sales reported on which the taxpayer did not accrue tax. If any excess debit or credit of tax still exists, after making the above adjustments, it should be the taxpayer's responsibility to explain such excesses.

In cases where a deduction is claimed for sales tax included in reported gross sales, the auditor should determine:

- a) That total amounts of sales tickets are entered in sales journal.
- b) If sales tickets are not prepared, that sales tax is rung up on the cash register if it is added to selling prices.
- c) That where sales tax is not added to sales prices, effect was given to the tax by the retailer in determining the total sales prices.

Regulation 1700 establishes the presumption that the selling price includes tax reimbursement if the taxpayer posts or provides the notices contained in Regulation 1700(a)(2)(C) 1. and 2. Failure by the taxpayer to satisfy these presumptions does not preclude acceptance of other evidence to support the tax included deduction. Claimed "tax included" deductions should be allowed unless there is sufficient evidence to rebut the taxpayer's claim. The mere failure to comply with the presumptions of Regulation 1700 is in itself insufficient proof that the retailer has not included the tax in the selling price.

This deduction is computed after the balance of the audit is completed and is based on audited sales (purchases subject to use tax not included) minus deductions. In order to avoid the allowance of sales tax included on disallowed deductions on which sales tax was not charged, the audited taxable sales (tax included) should be decreased by the amounts of such disallowed sales. Sales tax included in taxable sales may then be computed by multiplying taxable sales (tax included) by a factor.

The factor to be used can be computed as follows:

Factor =
$$\frac{\text{Tax Rate}}{1 + \text{Tax Rate}} = \frac{.0725}{1 + .0725} = .067599$$

Factors for other current tax rates are:

Tax Rate	Factor	Tax Rate	Factor
6.50%	061033	7.75%	071926
7.00%	065421	7.85%	072786
7.25%	067599	8.00%	074074
7.375%	068685	8.25%	076212
7.50%	069767	8.50%	078341

Sales tax included should be allowed in all audits where sales have been estimated if the basic factors in the estimate include sales tax. For example, where prices which include sales tax are used to develop a mark-up of purchases, the sales estimated by the mark-up method will have the tax included.

TREATMENT OF EXCESS TAX REIMBURSEMENT

0417.00

GENERAL 0417.05

Retailers sometimes charge their customers tax on exempt sales or, in the case of taxable sales, tax in excess of the amount due. Retailers who have collected excess tax reimbursement should be encouraged to refund the excess tax to their customers. Regulation 1700 explains the sales tax reimbursement rules.

Tax reimbursement greater than the amount of tax imposed upon a transaction is excess tax reimbursement to the extent that it exceeds the taxpayer's own tax liability on the same transaction. If the taxpayer has no tax liability on the transaction, the entire amount of reimbursement collected in excess of the tax imposed on the transaction is excess tax reimbursement and must be returned to the customer. If the taxpayer fails or refuses to return such excess tax reimbursement to the customer, it must be paid to the State whether it was mistakenly computed, or knowingly computed.

REFUNDS OF EXCESS TAX REIMBURSEMENT

0417.07

Regulation 1700 provides that refunds of amounts of excess tax reimbursement paid to the Board as sales tax may be refunded to the retailer upon submission of "evidence sufficient to establish that excess amounts have been or will be returned to the customer."

This has been construed to mean that the retailer must actually refund amounts collected as excess tax reimbursement to their customers rather than give a credit unless they can show one of the following:

- The customer agrees to a credit;
- The customer's debt to the retailer is acknowledged by the customer or made certain by a court proceeding;
- The amounts to be credited are small and apply to numerous customers.

In order to assure that such excessive reimbursement will, in fact, be returned or credited under the above circumstances to the customer it is suggested that prior to recommending to refund in an audit a letter similar to the following be obtained from the taxpayer:

In order to qualify for consideration	on of refund of excess sales and use tax reimbursement collected by
me during the period	the undersigned seller, hereinafter referred to as seller, agrees to do
the following:	

- Notify in writing each person from whom excessive tax reimbursement was collected the amount of tax that will be returned if and when the Board of Equalization refunds the tax to the seller.
- Provide on affidavit listing the persons to whom such notices were mailed or delivered and the amounts involved.
- Return the excessive tax reimbursement to the customers, or credit the customers accounts under conditions prescribed by the Board of Equalization.

I understand that failure to return the tax to the customer, or validly credit their account, within 30 days from the date received by the seller will subject the seller to appropriate action for recovery of the tax plus appropriate penalties.

Seller _				
By _				
FD1 1				
Permit N	Vo			
Address_				
_		 	 	-

0417.10

The auditor must audit not only on the basis of gross receipts, but must inquire into tax reimbursement on an individual transaction basis. An examination of the sales tax accrual account may indicate an over-collection of tax, however, the overage is seldom the amount of excess reimbursement. In some cases an overage will result from the breakage factor in following the prescribed reimbursement charts, which is not excess reimbursement. Tests of individual transactions by examining sales invoices, dinner tags, register tapes, contracts, etc., are necessary. When testing discloses a pattern of excess reimbursement to the extent necessary to support an informed opinion (Sec. **0404.15**) the auditor should so inform the taxpayer. If the taxpayer does not elect to refund the excess tax to their customers, or cannot, then the auditor should project, or expand the test to estimate the excess tax for the audit period. The measure of excess tax reimbursement disclosed by audit should be separately set forth in the audit report captioned "Measure of Excess Tax Reimbursement."

OFFSETS 0417.15

Offsets allow a taxpayer to satisfy their tax liability on a transaction by paying to the State an equivalent amount of tax reimbursement collected from a customer on the same transaction. Such offsets can be made only on a transaction-by-transaction basis. Tax reimbursement collected on a specific transaction can be used only to satisfy a tax liability arising from the same transaction. The "same transaction" means all activities involved in the acquisition and disposition of the same property. The "same transaction" may involve several persons, such as a vendor, a subcontractor, a prime contractor, and the final customer; or a vendor, a lessor, and a series of sublessors.

If tax reimbursement equal to or in excess of the tax liability on a transaction is collected and paid to the State, the taxpayer has no further tax liability. Any refund will be limited to the amount paid to the State in excess of the tax liability. If an audit discloses that tax reimbursement was collected in excess of the tax liability on the transaction, and that no tax has been paid to the State on the transaction, the tax liability will be assessed and the tax reimbursement in excess of that amount must be returned to the customer or paid to the State.

A taxpayer may offset tax reimbursement collected on a transaction against their tax liability on the transaction whether the liability was satisfied by paying sales tax reimbursement to a vendor, paying use tax to a vendor, or paying use tax to the State. Tax reimbursement collected from a customer on a transaction is excessive only to the extent that it exceeds the taxpayer's own tax liability on the same transaction.

An offset of a taxpayer's own tax liability against tax reimbursement collected from a customer can be made only with respect to *transactions in which possession of the property upon which the taxpayer's liability is based is transferred, either permanently or temporarily, to the customer*, as in the case of construction contracts or leases. A taxpayer, such as a repairman, who uses shop supplies in performing a job for a customer cannot offset their tax liability arising from the use of the supplies against tax reimbursement collected from the customer.

The following examples illustrate the application of tax to certain transactions engaged in by taxpayers.

Construction Contractors. A contractor furnishes and installs materials under a lump-sum construction contract for the improvement of real property, and collects tax reimbursement on the total contract price. The contractor must pay use tax, or sales tax reimbursement to the vendor, on the purchase price of the materials consumed in performing the contract. This tax or tax reimbursement may be offset against the tax reimbursement collected from the contractor's customer. The balance of the tax reimbursement collected from the customer must be returned to the customer or paid to the State.

A subcontractor furnishes and installs extax materials under a lump-sum contract to improve real property. The prime contractor collects tax reimbursement from the customer on the total contract price and pays all of the tax reimbursement collected to the State. The subcontractor's use tax liability on the materials consumed in performing the contract will be offset against the tax reimbursement paid to the State by the prime contractor to the extent that the subcontractor can show that the prime contractor paid the tax reimbursement to the State on the same transaction. The subcontractor has the burden of proving, for each transaction, that the prime contractor paid the tax reimbursement to the State. No offset will be allowed for those transactions where no such proof has been provided. The tax reimbursement paid to the State by the prime contractor in excess of the use tax liability of the subcontractor will be refunded to the prime contractor only if it is returned to the customer.

In audits of the prime contractor, the prime contractor should be given an opportunity to choose among the following options.

- Refund excess tax reimbursement to the customer. Under this alternative, the subcontractor would owe tax on the cost of the materials and no offset would be available. If the prime contractor had issued a resale certificate to the subcontractor, the prime contractor could also be held liable for the subcontractor's use tax liability pursuant to Section 6094.5 of the Revenue and Taxation Code.
- Take no further action. Under this alternative, the subcontractor may offset its use tax liability against the tax reimbursement paid to the State by the prime contractor.
- Refund to the customer the difference between what the prime contractor collected as tax reimbursement and the subcontractor's use tax liability. However, in order to choose this option the prime contractor must establish the subcontractor's tax cost for each transaction. Under this alternative, the subcontractor may offset its use tax liability against the tax reimbursement paid to the State by the prime contractor to the extent that such amounts have not previously been refunded.

In all cases, once an offset has been made pursuant to Section 6901.5, the amount offset no longer represents excess tax reimbursement paid to the State on the original transaction. Therefore, a prime contractor is not entitled to a refund of amounts originally remitted to the State by the prime contractor but later offset against the subcontractor's use tax liability arising out of the same transaction.

Lessors of Mobile Transportation Equipment. A lessor of mobile transportation equipment purchases such equipment extax under a resale certificate and collects tax reimbursement on the rental receipts, but pays no tax to the State. The lessor must pay tax on the purchase price of the equipment since a timely election to measure the tax by fair rental value was not made. However, the tax reimbursement collected on rental receipts is excess tax reimbursement only to the extent that it exceeds the tax liability measured by the purchase price. Such excess tax reimbursement must be returned to the lessee or paid to the State.

Other Lessors of Tangible Personal Property. A lessor purchases property and pays sales tax reimbursement on the purchase to the vendor. The property is leased in the same form as acquired and tax reimbursement is collected on the rental receipts. To the extent that the tax reimbursement collected on rental receipts exceeds the tax reimbursement paid on the purchase price, it must be returned to the customer or paid to the State. The law applies in this manner whether the property is leased to a single lessee or a series of lessees.

AUDIT OF PRESCRIPTION MEDICINES

0418.00

GENERAL 0418.05

Medicines sold under a prescription issued by a physician, dentist, surgeon, or podiatrist for the treatment of a human being, and filled by a registered pharmacist, are exempt from the sales tax. For definitions of terminology, and other conditions under which medicines are exempt, see the applicable sections of the law, rules and regulations. From an audit standpoint exempt sales to and by doctors, dentists, hospitals and certain political entities present no particular problem. The following section is limited to auditing prescription pharmacies.

AUDITING PROCEDURE

0418.10

Section 4331 of the Business and Professions Code requires that all prescriptions filled shall be kept on file and open for inspection by duly constituted authorities. Also, Regulation 1591 requires that "any deduction on account of sales of medicines shall be supported by appropriate records". The only records specifically required by regulation are the prescriptions themselves, which must be numbered and filed in numerical sequence. Refills are required to be noted on the reverse side of the prescription, or on a separate attachment thereto, with the date of refilling and initialed by the pharmacist.

Many pharmacies keep a "prescription register" to record the prescription number, prescriber's name, patient's name, date sold, and the sales price of the prescription. When pharmacies use this "register" as a basis for their deduction the auditor need only apply normal verification techniques to determine the accuracy of the claimed deduction. Where such a "register" is not kept, the auditor should first determine taxpayer's method of compiling the deduction and apply appropriate testing techniques to verify the accuracy of the detail supporting the compilation of the deduction. The auditor should be mindful of the requirement in Regulation 1591 that the taxpayer must support the claimed deduction by appropriate records.

AUDIT OF BAD DEBT DEDUCTIONS — GENERAL

0419.03

A deduction may be claimed for the measure of tax represented by accounts on which the retailer paid the sales or use tax and which were found to be worthless and charged off for income tax purposes, or if the retailer is not required to file income tax returns, charged off in accordance with generally accepted principles. That the account was written off is sufficient to allow the deduction if all other prescribed conditions are met. The auditor need not be concerned with whether the account is actually worthless. Bad debts may originate from sales on open accounts, unsecured installment sales, or from repossessions of merchandise sold on a conditional sales contract.

Amounts charged off usually will be greater than amounts allowable as a deduction under the Sales and Use Tax Law. This is because amounts charged off may include charges for sales tax reimbursement, labor, cartage, etc., or the whole amount may represent a sale for resale or a sale in interstate or foreign commerce. The auditor must therefore analyze the sales which are the basis for claimed bad debt deductions, either on an actual or test basis.

Generally a retailer has bad debt deduction if the selling price upon which tax was reported and paid is more than the payments, trade-in allowances, and other credits applicable to the sale. The wholesale value of merchandise repossessed is an example of "other credits."

The allowable loss for sales and use tax purposes is the pro-rata portion of the book loss which the taxable sales price of the tangible bears to the total sales price which may include exempt tangible items composing the sale.

An example of a computation of the allowable loss follows:

Original Sales Price Tangible Personal Propert	:y	\$200
Installation Labor and Insurance		10
Sales Tax		12
Gross Sales Price		\$222
Total Consideration Received:		
Cash Down	\$50	
Cash paid on Account	25	<u>75</u>
Book Loss per Records		<u>\$147</u>
Loss Allowable for Sales Tax Purposes:		

$$\frac{$200}{$222} \times $147 = $132$$

Many retailers fail to claim a bad debt deduction. If at the time of audit the taxpayer has not worked up the data to support an allowable deduction, they should be furnished the format as outlined in Regulation 1642 and asked to compile the information.

Verification of bad debts may be made on a test basis. Representative periods should be selected with concurrence of the taxpayer. The percentage of overstatement or understatement computed during the test periods will be applied to all other periods of the audit. Audited differences will be used for the test periods.

Certain larger retailers such as department stores are authorized to compute deductions on a formula basis. Formulas approved by the Board take into account the retailer's bad debt experience, both as to losses and recoveries, over substantial periods of time. Such a formula appears in Section 1105.45.

The auditor should review the accounting records and income tax returns to determine that bad debts have been properly written off. Auditors should satisfy themselves that the method used by the taxpayer to arrive at the allowable deduction is substantially correct. Special attention should be directed to the following:

- Was Sale Prior to a Change in the Tax Rate?
 - An adjustment must be made to compensate for the tax rate differential between sales made at one rate and claimed as bad debts after the rate has changed or a district tax has been added or discontinued. The audit report should be completed in such a manner than tax credit will be given for state, local, county and district tax.
- Effect of Charging an Account Other Than Bad Debt Expense For the Repossession Loss
 Many accounting systems require charging repossession losses directly against the cost of goods sold or other cost account rather than Bad Debt Expense. This method has the same general effect on the financial condition and therefore is an acceptable write-off method.
- Effect of Reporting on a Cash Basis
 - If retailers have been reporting their sales tax liability on a cash basis, ordinarily no bad debt deduction will be allowed. This is because sales tax has not previously been paid on the accounts deemed to be worthless. If accounts receivable have been picked up in a previous audit a bad debt deduction may be allowed for any such receivables which subsequently go bad even though the taxpayer continued to report on a cash basis.
- Consolidation of Debts
 - The auditor should assure themselves that the remaining contract balance (net payoff) is a measure of the taxable sale only. Some retailers consolidate other debts of the customer into the contract which do not pertain to the allowable loss.
- Worthless Accounts Subsequently Collected
 - General accounting records should be reviewed to determine that collections of previously written off accounts have been properly reported for sales tax purposes. These should be reported on the same pro-rate basis used for claiming the bad debt deductions, i.e., ratably allocated to the taxable and nontaxable elements of the original sale. If, however, delinquency charges have accrued, collections may be applied to such charges first and remainder then pro-rated to determine the taxable portion to be reported.
- Collection Expense
 - Collection agencies charge a fee for their services, normally 50% of the amount collected by them. Any amount paid directly to or retained by a collection agency in attempting to enforce collection of amounts owing is not allowable as part of the bad debt loss.
 - Review should be made of receipts from the collection agency to assure that amounts shown as collected are gross, including the collection charge.
- Insurance Indemnification
 - Review of accounting records should include a search for insurance recoveries on accounts receivables, property damage, and similar type insurance policies applicable to sustained bad debt losses. Any such indemnification should be used to reduce the allowable bad debt loss.

The verification of repossession losses should include, as standard procedure, sufficient testing to insure that all repossessed merchandise is brought back into inventory or has been resold. A comparison of the value used for computing the bad debt loss with the subsequent selling price should show a reasonable relationship.

Bad Debts Incurred by Lessors

- A bad debt deduction is allowable on reported taxable rental receipts which are found to be worthless and charged off for income tax purposes.
- On leases or renewals of leases, the lessor is required to collect use tax from the lessee at the time rentals are paid by the lessee and to pay the tax during the corresponding reporting period. If the lessor has computed and paid tax to the state on lease payments that were due but not paid by the lessee, then the lessor has made a tax overpayment subject to refund or credit. Therefore, the taxpayer may claim a refund without having to write off the account as a bad debt for income tax purposes. If however, the account was properly written off and claimed as a bad debt deduction, it should be allowed.
- When leases of tangible personal property situated in this State are not subject to use tax because of the exempt status of the lessee (e.g. insurance companies) the lessor nevertheless is subject to sales tax measured by the rental receipts. Therefore, taxes are due from the lessor on the basis of <u>rentals payable</u> and not <u>rentals paid</u>, and a valid bad debt deduction may result for sales tax purposes.

Bad Debt Deductions to Persons Other Than the Retailer

- A successor who pays full consideration for receivables acquired from their predecessor is entitled to a
 bad debt deduction to the same extent that the predecessor would have been had they continued the
 business.
- A purchaser of receivables, other than a successor, cannot obtain a bad debt deduction on accounts that cannot be collected.
- A retailer who sells receivables at a discount cannot obtain a bad debt deduction for the amount of the discount.

Bad Debts of Construction Contractors

- When under a time and material contract a contractor bills their customer for tax reimbursement computed upon a marked-up price for materials, pays the tax accordingly and the receivable is thereafter found to be worthless and charged off for income tax purposes, or if the contractor is not required to file income tax returns, charged off in accordance with generally accepted accounting principles, a bad debt deduction may be taken by the contractor for the total amount. The contractor is a retailer in this situation.
- Since a contractor is the retailer of fixtures (other than those used in performance of contracts with the United States) bad debt losses incurred in connection with the furnishing and installing of fixtures are to be treated in the same manner as those resulting from other types of retail sales.

CREDIT FOR TAX PAID TO OTHER STATES, SECTION 6406 CREDIT 0419.20

Credit for sales or use tax imposed by other states and paid on purchases of tangible personal property may be taken as a credit against the amount of tax due. The property must have been purchased for use, consumption or storage (not resale) in California.

Auditing procedure normally includes verifying the purchase invoices to ascertain that the purchase price was included on Line 2 of the return and to verify the amount of Section 6406 credit claimed on the return. The auditor must also verify that the tax (amount of credit claimed) was paid either to the retailer located in another state or to that state itself. The tax which was paid must have been properly imposed on the purchaser. Section 6406 also provides that credit is not allowed on out-of-state tax measured by periodic payments made under a lease for a period prior to the storage, use or other consumption of the property in this State.

The amount of tax credit claimed may not exceed the lesser of (1) the tax actually paid and owed to another state, or (2) the tax computed using the combined state and local tax rates in effect at the time the property was first brought to California. Section 0203.16 describes the method of handling the difference developed in this portion of the audit.

The Section 6406 credit is apportioned to the state tax and local tax against which it is allowed in proportion to the amounts of those taxes.

TAX PAID PURCHASES RESOLD

0419.25

Regulation 1701 provides that a retailer who resells tangible personal property before making any use thereof (other than retention, demonstration or display while holding it for sale in the regular course of business) may take a deduction of the purchase price of the property if, with respect to its purchase, the retailer has reimbursed their vendor for the sales tax or has paid the use tax.

The allowable deduction is the original purchase price of the property upon which tax has been paid regardless of the subsequent sales price. If this type of property is sold at a loss, the deduction is still allowable on the basis of the original purchase price. The following examples illustrate the allowable deduction:

Original purchase price	\$500	\$500
Tax paid 6%	30	30
Subsequent sales price	500	700
Sales tax 6%	30	42
Allowable deduction	500	500

Where a different rate of tax was in effect at the time of purchase, the deduction must be adjusted accordingly. If the deduction has not been claimed, credit should be allowed at the time of audit.

Exceptions to this policy are:

- Property acquired on a tax-paid basis and leased in substantially the same form as acquired cannot be converted into a sale by taking a tax-paid purchases resold credit.
- Property acquired on a tax-paid basis and placed in standby service will be considered used. This will
 preclude a tax-paid purchase resold deduction if the property is located at the place of intended use and
 committed to that use, even though never physically used there and it is ultimately removed and sold.

If credit is allowed for tax-paid purchases resold and there is some question that the supplier might also refund the tax, the facts should be stated in a memorandum and forwarded to the district office in which the vendor is located.

AUDIT OF CHARITABLE ORGANIZATIONS

0419.30

Sales made by charitable organizations are exempt provided the conditions included in Regulation 1570 are met. CPPM Section 225.050 also contains information relating to charitable organizations.

Included among the conditions that must be met is that each year a "welfare exemption" from property taxation must be secured. The exemption claim is filed through the County Assessor's Office by March 15 of each year. Sales are taxable during a year for which an organization does not qualify for a "welfare exemption". The procedure by which an organization qualifies for an exemption appears in CPPM. The auditor should ascertain that the exemption covers all real and/or personal property owned by the organization and situated at the location from which the sales are made. An organization not owning the real property must qualify for an exemption of the personal property at that location.

Organizations that started after the filing date should make application to the County Assessor to find out whether or not they qualify for the exemption. The organization should receive a letter, which informs them that they qualify, from the Assessor or Division of Assessment Standards. Such a letter exempts them from the payment of sales tax pending their qualifying at the normal filing time.

Sales or use tax applies to sales to charitable organizations of tools, supplies, and equipment when the property is used or consumed by the organization. Effective January 1, 1990 sales or use tax does not apply to purchases by the organization of tangible personal property for the purpose of donation.

AUDIT OF WATERCRAFT EXEMPTION CERTIFICATES

0419.35

All claimed exempt watercraft sales must be supported by properly completed exemption certificates. It is especially important that questionable certificates be followed up to substantiate their validity.

Occasionally a purchaser may issue an exemption certificate for items that may be taxable or nontaxable depending upon attachment and/or usage. In which case, items of a consumable nature should be considered as taxable unless the purchase order indicates these items as exempt.

The sales of watercraft and their component parts are exempt, provided the conditions included in Regulation 1594 are met.

To be considered a "component part" of a watercraft for purposes of the exemption the property must be an integral part of the watercraft, affixed or attached thereto in a substantial manner when in use. All property affixed or attached to the structure of the watercraft used while thus affixed or attached for navigation, operation, or for the comfort or convenience of the passengers and crew is exempt.

Property is not considered a component part of a watercraft for purposes of the exemption if it is a kind commonly treated as expense items and is not affixed or attached to the watercraft in a substantial manner when in use. For further details, see Pamphlet Number 40, Tax Tips For The Watercraft Industry.

AUDIT OF EXEMPT SALES OF AIRCRAFT

0419.40

During an audit of a California aircraft dealer or dealer/broker the auditor shall schedule leads on certain apparently valid and properly supported exempt sales of aircraft as follows:

- All exempt sales to nonresidents other than bonafide dealers.
- Any exempt sales to common carriers or foreign governments which seem to be valid but which might have some questionable aspects.
- All brokerage transactions.

Form, BT–379–A, Aircraft Exempt Sale Referral, was developed for this purpose (**Exhibit 8**). The auditor shall perform sufficient verification to ensure that no transactions are listed which are properly the liability of the taxpayer under audit, i.e., list only transactions which audit verification indicates are the responsibility of the purchaser rather than the dealer.

Whenever the auditor disallows sales of aircraft to nonresidents, convincing verification should be obtained that the purchaser was or is a California resident. Evidence of a factual abode of some permanency in California should be obtained in these situations.

It should be determined that the dealer has not in effect encouraged false documentation. If it can be established that the dealer knew the facts stated in the documentation were not true, the tax plus applicable interest and penalties should be assessed against the dealer. A dual determination against the purchaser might be justified in some situations.

All such listings of transactions should provide as much information as possible but should include as a minimum: The name and address of the purchaser and seller; the type of aircraft including make, size, description and identification number; the state in which the aircraft is registered; the selling price; and the basis on which the transaction was claimed as exempt, i.e., nonresident, common carrier, foreign government or brokerage. A separate Form BT–379–A should be prepared for each transaction.

Transactions should also be listed during audits of other accounts involving exempt sales or aircraft where the purchaser would be responsible for tax such as:

- Sales of aircraft by other instate sellers (nondealers) to residents and nonresidents.
- Sales of aircraft by out-of-state sellers (dealers and nondealers) to California residents and sales to nonresidents that may have some indications that the aircraft was purchased for use in California.

The Forms BT–379–A on such ostensibly exempt sales transactions should be forwarded directly to the Consumer Use Tax Division. They will correlate this data with their own sources of information and prepare use tax billings where appropriate.

AUDIT OF EXEMPT SALES AND PURCHASES OF NEW OR REMANUFACTURED TRUCKS, TRUCK TRACTORS, TRAILERS, OR SEMITRAILERS 0419.45

All claimed exempt sales of new or remanufactured vehicles must be supported by written evidence of out-of-state license and/or registration and an affidavit as required by Section 6388 or 6388.5. The affidavit can be in any form provided it satisfies the requirements of those sections (**Exhibit 9**). However, for any affidavit to be valid, written evidence of out-of-state license and/or registration is required. The written evidence of out of state license and/or registration can be in the form of a prorate registration even though the vehicle is baseplated in California.

In auditing a purchaser who is engaged in business in this state, the purchaser must provide documentary evidence that any vehicle claimed as exempt pursuant to Section 6388 or 6388.5 was removed within the time provided by these sections. Examples of documentary evidence are fuel receipts, hotel bills, bills of lading for the first use of the vehicle and copies of license or registration fee receipts showing the date of payment. For the exemption under Section 6388 to apply, the purchaser must also show that the vehicle was first used and functionally used thereafter out of state. For the exemption under Section 6388.5 to apply, the purchaser must also show that the vehicle was used exclusively outside the state, or exclusively in interstate or foreign commerce, or both.

An example of use in interstate commerce is if the purchaser removed the trailer or semitrailer from this state within the appropriate time limits with an <u>interstate</u> payload. Failure of the purchaser to substantiate compliance with these two requirements are grounds for disallowance of the exemption and assessment of sales tax against the purchaser measured by the acquisition cost of the vehicle.

SALES TAX EXEMPTION FOR FOREIGN DIPLOMATS

0419.50

Effective February 15, 1986, the U.S. Department of State began issuing Tax Exemption Cards to foreign diplomatic personnel who are exempt from sales tax. Each card includes the name of the person to whom it is issued, personal identification information, a photograph, an expiration date, and a tax exemption number. Many diplomatic personnel who enjoyed an exemption from sales taxes under the former program (in which cards were issued by the Board) have been denied immunity entirely. The U.S. Department of State cards will specify either that the holder of the card is exempt from sales tax on all sales or that the holder of the card is exempt from sales tax only on transactions which exceed an amount stated on the card. For example, if the tax exemption card is granted for a minimum level of exemption of \$50, as indicated on the card, the purchaser must purchase merchandise aggregating over \$50 in a single transaction to qualify for the exemption. The total purchase may be composed of all taxable merchandise or a combination of taxable and non-taxable merchandise, i.e., a sale of cigarettes for \$6 is exempt if sold together with \$45 non-taxable food products. Separate purchases in the same store will not qualify if the amount of each transaction does not exceed the amount indicated on the card, even though the combination of all individual purchases in that store may exceed that amount.

To support the exemption, the retailer must prepare and retain an invoice or other written evidence of the sale and should enter the name of the purchaser, the number of the exemption card, the name of the foreign mission, the expiration date of the card, and the minimum level of exemption specified on the card, if any.

The U.S. Department of State will provide the Board with quarterly printouts of current card holders and will respond to telephone inquiries regarding the validity of cards issued in the interim on a routine basis. The printouts will be maintained in the Headquarters Compliance Planning and Evaluation Unit. Any questions regarding the validity of a card should be directed to that unit.

For special rules regarding sales of vehicles, see Chapter 6 "Motor Vehicle Dealers."

EXEMPT SALES OF FOOD PRODUCTS — THE 80–80 RULE

0419.55

When auditing businesses such as restaurants, fast food establishments, concessionaires, soda fountains, and other similar establishments particular attention should be paid to exempt food sales with respect to the 80–80 Rule of Regulation 1603. The 80–80 Rule applies if:

- 1. more than 80% of the retailer's gross receipts at a retail location come from the sale of food products (not including such items as carbonated or alcoholic beverages, or cigarettes) **and**
- 2. more than 80% of the retail food product sales are taxable because they are:
 - food products sold as a meal
 - food products furnished, prepared, or served for consumption at facilities provided by the retailer
 - food products ordinarily sold for immediate consumption at an establishment which is defined as a "drive-in"
 - food products sold as hot prepared food.

Sales such as "cold food to go" which may become taxable under the 80–80 criteria **should not** be used in computing the taxable percentage.

Likewise, food which is furnished in a form **not** suitable for consumption on sellers premises **should not** be included in the computation. These foods will <u>not</u> become taxable even if the retailer meets the 80–80 criteria, and include such foods as:

- items not ordinarily consumed because they require further processing, cutting or assembly such as:
 - a whole cold chicken
 - party trays of meats and cheeses
 - hors d'oeuvres prepared and sold to go

- food products typically altered before being consumed
 - plain croissant (usually cut and stuffed)
 - a dozen dinner rolls (assembled with a meal, cut and buttered)
 - a whole pie or cake (cut into individual portions)
- container size not suitable (obviously has more than one serving, and must be subdivided before serving)
 - one quart of salad
 - one quart of ice cream
 - bottled ice cream toppings
 - · a loaf of bread
 - a bottle of barbecue sauce

When the taxpayer operates more than one type of food operation, e.g., several drive-ins and fast food restaurants or concession stands at swap meets or fairs, each individual location will be considered separately in determining if they meet the criteria.

For businesses that meet the conditions of the 80–80 Rule, food sales on a "take out" or "to go" basis are subject to tax when the food is *in a form suitable for consumption on the seller's premises*. This includes bulk quantities of food sold in a "drive-in" establishment described in Regulation 1603(b). However, if a "drive-in" establishment does not meet the 80% criteria, the sales of items such as a dozen donuts or six pints of milk will remain exempt under the definition of bulk quantities in the regulation.

If a retailer has a food operation business or a location of the type that would ordinarily meet the 80–80 criteria, but the taxpayer has been claiming an exemption for food, a test of current sales should be made to determine if all sales should be taxable under the 80–80 Rule. If the 80–80 criteria is met in the test, claimed exemptions for food will normally be disallowed for the entire audit period unless:

- the retailer can demonstrate that there was a significant change in business operations during the audit period, or
- the character of business changes significantly during certain seasons of the year.

In these cases, deductions for food should be disallowed for the periods that the auditor determines the 80–80 criteria was met. Also, the 80–80 Rule will apply prospectively unless the taxpayer wishes to maintain detailed records on a continuing basis to support any claimed food deductions.

If the test of current sales does not meet the 80–80 criteria, but falls in the range of 75% — 80%, the taxpayer should be advised to periodically test sales to insure that the 80–80 criteria is not exceeded, and to apply tax prospectively if the criteria is exceeded. The taxpayer must document and retain the results of any tests performed.

AUDIT OF FOOD STAMP DEDUCTION

0419.60

Products which are <u>eligible</u> to be purchased with food stamps and <u>are</u> so purchased are not subject to the sales and use tax. Products which are normally taxable, but are exempt when purchased with food stamps include among other things: non-alcoholic carbonated beverages, ice, fruit trees, and berry vines. This deduction will normally be found when auditing grocery stores, however, it could be claimed by mini-marts, liquor stores, drugstores with food sections, and other retailers which are eligible to accept food stamps.

Taxpayers may claim the deduction on an actual basis, as an amount equal to 2% of the food stamps redeemed during the period of the return, or as a percentage computed by the taxpayer in accordance with Regulation 1602.5(c).

As this deduction will usually be rather small, any large claimed deductions will warrant careful examination.

AUDIT OF LEASES 0420.00

GENERAL 0420.05

There are three basic ways that the tax applies to leases, and the variability of this treatment depends on the type of property being leased, the means by which a lessor obtained the property, and the contract between the lessor and lessee. Some leases are taxed based on the cost of the property being leased, some are taxed based on the rental receipts, and some leases are taxed based on the fair rental value of the property being leased. Regulations 1660 and 1661 explain the application of tax to leases.

AUDITING PROCEDURE

0420.10

The auditor should determine the taxpayer's method of reporting tax on leased property. Most taxpayers choose one reporting method (cost, rental receipts or fair rental value) and use that method exclusively for all lease transactions. Under this situation the audit may be made on either a complete or test basis depending on the number and dollar value of the lease transactions. When a taxpayer reports leases under more than one method, a more detailed analysis of the transactions will be required to assure there are no errors in reporting lease transactions.

Auditors should always keep in mind the various criteria that are applied to leases to determine the application of tax:

- How was the property obtained by the lessor?
- What is the nature of the property being leased?
- Was the election of the lessor made timely?
- Is the transaction a lease or sale?

The auditor should be alert to the following areas that cause misunderstandings in the application of tax to leases:

- Sale and use exempt from sales and use tax because the sale was an occasional sale.
- Property affixed to realty.
- Tax paid to another state.

TIMELY ELECTION 0420.15

It should be stressed that in order for a lessor to utilize the available options to determine the measure of tax, an election must be made timely. Generally, a timely election means that the election must be made on the return for the reporting period in which the leased equipment first enters lease service. Clerical oversight is <u>not</u> an acceptable excuse for not making a timely election. Once the election is made, it is irrevocable.

ITEMS INCLUDED IN RENTAL RECEIPTS

0420.20

The following items are generally considered to be included in rental receipts (these rules apply when the rental receipts are subject to tax):

- LICENSE, ROYALTY, REPRODUCTION RIGHTS. If a rental or lease agreement calls for a royalty to be paid based on units produced or for use of the property, such royalties are includable in rental receipts. For example: a transfer of possession, but not title, of artwork to another person for reproduction is a lease or rental of the artwork.
- **ADVANCE RENTALS.** Advance rental payments received by the lessor at the time the lease commences are subject to the tax at the time the amounts are paid by the lessee. It is immaterial that the advance rental payment is designated as applicable to the final period of the lease. Generally, if the amount collected at the commencement of a lease is designated as a "security deposit" rather than an advance rental, the amount collected would not be subject to tax until it is actually applied to a rental payment.

- **CHARGES DESIGNATED AS INTEREST.** When equipment is actually leased and not sold on credit the amounts designated by the lessor as interest which are payable by the lessee, in addition to amounts designated as rentals, are includable in the rental payments subject to tax.
- **PROPERTY TAX.** When a lessee is required by the rental contract to pay for any personal property taxes assessed on the lease property, such amounts will be regarded as part of the taxable rental receipts whether the tax is assessed directly against the lessee or the lessor.
- MANDATORY CHARGES. When the lessee is obligated under the lease contract to use services provided by the lessor such as equipment maintenance, warranty, assembly, disassembly, etc., such additional charges are includable in rental receipts. However, if the lease contract merely requires that the lessee maintain the property, the lessee's maintenance costs are not includable in rental receipts. Another example of mandatory charges is the collision damage insurance supplement offered generally by daily car rental companies. If it is required that the customer purchase the insurance as part of the rental agreement, such charges are includable in rental receipts.
- **DEFICIENCY CHARGES**. These charges generally represent the difference between the actual value of the property returned to the lessor by the lessee at the termination of the lease and the value of the property prescribed in the lease contract upon which the periodic rentals were based. Such additional deficiency charges are includable in rental receipts. On the other hand, credits to lessees represent a reduction in rental receipts if these adjustments are called for in the lease contract.
- **DELIVERY CHARGES.** In those circumstances where delivery of tangible personal property is made by facilities of the lessor (as distinguished from an independent contract carrier), the delivery charge is included in the measure of tax unless the transportation occurs after possession of the leased property is transferred to the lessee or after the right to possession is granted to the lessee and the delivery charges are separately stated.
 - Charges for delivery made by an independent contract carrier may also be taxable where the sale is made for a delivered price.
- **RETURN TRANSPORTATION CHARGES.** Transportation charges at the termination of a lease for return of rented property from the lessee to the lessor are subject to tax unless the lessee has the option to provide his own return transportation. Such charges must also be separately stated and not be included with delivery charges in order to be exempt.

ITEMS EXCLUDED FROM RENTAL RECEIPTS

0420.25

The following items are generally considered to be excludable from rental receipts subject to tax (these rules apply when the rental receipts are subject to tax):

- **OPTIONAL CHARGES**. These are the opposite of mandatory charges discussed previously. For example, when the lessee is not obligated to use the maintenance or other service provided by the lessor, or to accept the collision damage insurance supplemental offered by the daily car rental company, but chooses voluntarily to do so, the additional charges are not includable in rental receipts subject to tax.
- **LATE CHARGES.** An additional payment made by a lessee for failing to pay the rental payment timely is not regarded as part of the taxable rental receipts.
- AUTOMOBILE ANNUAL LICENSE FEES. The annual license fees and taxes on motor vehicles are not includable in rental receipts whether paid by the lessor or lessee. This differs from the treatment of property tax. The annual license fees and taxes on vehicles are specifically exempt by law from the measure of tax.

SALE OF LEASED PROPERTY BY LESSOR

0420.30

Sale of leased property by the lessor is subject sales or use tax in the same manner as sales generally. The election chosen by the lessor at the commencement of the lease does not alter the tax application to sales of leased property by lessors. Where the lease agreement provides the lessee with an option to purchase the leased property, a sale occurs and tax is due based on that sale at the time the option is exercised.

REPAIR AND MAINTENANCE CONTRACTS

0420.35

Sales tax does not apply to sales of repair parts to a lessor which are used by the lessor in maintaining the leased equipment pursuant to a mandatory maintenance contract where the rental receipts are subject to tax. Such repair parts are regarded as being part of the sale of the leased item and may be purchased for resale.

The lessor is the consumer of repair parts used to repair equipment where an optional maintenance agreement exists. If the lessor makes a separate charge to the lessee, the lessor is a retailer of the parts.

FUEL USED IN RENTAL VEHICLES "WET RENTALS"

0420.40

A "wet rental" is a lease of a vehicle in which the total rental charge includes fuel furnished by the lessor. Whether the sale of the fuel to the lessor is subject to sales or use tax depends on whether the lessor is the retailer or the consumer of the fuel furnished.

Lessor is Retailer of Fuel. — When the lease of a vehicle is subject to tax as a continuing sale, the lessor is the retailer of fuel furnished under wet rentals of the vehicles. Such fuel may be purchased extax under a resale certificate., and if sales or use tax is reported and paid on the total rental receipts no additional tax liability accrues.

Lessor is Consumer of Fuel. — When the lease of a vehicle is not a continuing sale because tax has been paid on the cost of the vehicle, or because the vehicle is mobile transportation equipment, the lessor is the consumer of fuel furnished under a wet rental, and tax applies to the sale of fuel to the lessor. However, if the lessor makes a separate charge to the lessee for the fuel, the lessor is the retailer of such fuel and the retail sale of the fuel is subject to sales tax. In that case the lessor may purchase the fuel ex-tax under a resale certificate.

AUDIT OF SALE AND LEASEBACK TRANSACTIONS

0420.45

In analyzing sale and leaseback transactions, the primary consideration is the intent of the parties at the time they entered into the transaction i.e., did the parties intend to sell the equipment and enter into a subsequent lease or did the parties intend to enter into a financing agreement. If the agreement describes the transaction as a sale transaction and as a lease transaction, this is some evidence that the parties intended that the transaction have those legal effects. Consequently, all sales and leaseback transactions should be taxed in accordance with their express terms unless it is clearly established that the transactions are financing agreements.

Taxpayers must establish that <u>all</u> of the following factors are present to establish that a transaction, which is in the form a sale and leaseback, is, in substance, a financing transaction only.

- 1. Ownership of property under the contract reverts to the "lessee" upon completion of all lease payments. The presence of an option to purchase in a leaseback agreement does not itself necessarily preclude the transaction from being treated as a loan for sales and use tax purposes. The fact that title might not pass automatically to the "lessee" at the end of the lease term, or upon the payment of a mandatory amount (whether nominal or not), but only upon the payment of an option price, will not in itself result in the transaction being treated as a sale and leaseback, provided the economic circumstances (option price is fair market value or less) are such that it is readily apparent that the option will be exercised.
- 2. Financing agreements, as provided for under the Commercial Code, were filed by the parties.

- 3. The treatment of the transaction for state and federal income tax purposes is consistent with the parties contention that the agreement is a financing agreement. On the other hand, if the parties have treated the transaction as a sale and leaseback for income tax purposes, this is a clear indication that the parties intended that there be a sale and leaseback of the property. Therefore, if the transaction is intentionally structured by the parties to realize income tax benefits from a sale and leaseback, the intention of the parties that the transaction be given effect in accordance with its form has been clearly established and the transaction will be treated as a sale and leaseback for sales and use tax purposes.
- 4. The amount which would be attributable to interest had the transaction been structured originally as a financing agreement is not usurious under California law. Where a transaction is entered into as a sale and leaseback which would be in violation of the usury provisions of this state if cast in the form of a loan, then the transaction will be given validity in accordance with the express terms of the agreement and will be treated as a sale and leaseback for sales and use tax purposes.
- 5. In situations where the "lessee" defaulted, the "lessor" resorted to the legal remedies available to a secured party as opposed to legal remedies available to an owner of leased property.

If all the factors as enumerated above are present, then the transaction would qualify as a financing agreement for sales and use tax purposes.

AUDIT OF LEASE TRANSACTIONS WITH GOVERNMENTAL BODIES 0420.50

Section 6006.3 provides that governmental bodies shall be treated as bound for a fixed term, notwithstanding any right to terminate the contract in the event that sufficient funds are not appropriated, and that these contracts are included in the definition of a "sale under a security agreement."

If such a contract with a governmental agency is voluntarily terminated by the agency, the agency technically is not in default. However, the seller will be allowed to claim a repossession loss under the guidelines of Regulation 1642, Bad Debts (Section **0419.03**)

Any transaction regarded under Section 6006.3 as a sale under a security agreement with a governmental body, which has been designated as a lease because of budgetary restrictions and which was still active as of January 1, 1987, shall be classified as a sale on that date. This applies to transactions involving both mobile transportation equipment and other tangible personal Property.

The sales price that must be reported is the original contract price, net of finance charges, amounts billed for insurance and other non-taxable items. Amounts which were included in the original contract and collected by the lessor/seller after January 1, 1987, will not be considered as additional gross receipts when collected.

Any sales or use tax previously paid on one of these transactions may be credited against any sales or use tax due on that transaction. This credit may be applied only against tax due on the same transaction. If the use tax paid on the "lease" exceeds the tax due on the sale, the taxpayer may file a claim for refund. Audits which include such refunds should follow the instructions regarding refunds (Section **0402.20**).

When the property is mobile transportation equipment, the sellers (lessors) have been reporting their own use tax liability, measured by fair rental value. Consequently, the sellers (lessors) of mobile transportation equipment are not required to refund to their customers any overpayments of use tax paid on the "leases".

When the property involved is not mobile transportation equipment, the sellers (lessors) have been collecting and remitting the lessees' use tax. The amount of use tax paid on each "lease" will be offset against tax due on the sale, on a transaction by transaction basis. In cases where an overpayment has been made, no refund or credit against the seller's existing liability will be made until the requirements of Regulation 1700 have been met (Section **0417.07**).

AUDIT OF MOTOR VEHICLE FUEL

0430.00

GENERAL 0430.05

Sales or use tax applies to retail sales of fuel taxed under the Motor Vehicle Fuel License Tax Law. The tax applies to the total selling price of such motor vehicle fuel, *inclusive* of federal and state excise taxes. Sales tax does not apply to retail sales of motor vehicle fuel for use in propelling aircraft, regardless of the fact that it is automotive gasoline. Aircraft jet fuel is subject to sales tax unless used on international flights.

Sales or use tax applies to sales of diesel fuel, liquefied petroleum gas (LPG), liquefied natural gas (LNG) and compressed natural gas (CNG). CNG may be exempt if it is delivered to the retailer in gaseous form through pipes or lines from the natural gas supplier and compressed by the retailer. Tax applies to the selling price of the fuel, *inclusive* of federal excise taxes, but *exclusive* of state excise taxes (e.g., Diesel Fuel Tax).

AUDITING PROCEDURE

0430.10

An inventory reconciliation should be made to verify that recorded purchases include all receipts of motor vehicle fuel, and that metered withdrawals from storage are correctly reported in gallon and dollar amounts Section 0446.10). Total gallons sold times unit selling prices should agree with reported sales of motor vehicle fuel. This accountability procedure should help the auditor determine whether a detailed audit is warranted.

METHODS OF VERIFICATION

0430.15

Where records are inadequate, it may be necessary to base the verification of sales of motor vehicle fuel on purchases converted to the selling price. Since most service stations sell fuel obtained from one distributor, a schedule of purchases should be obtained from that company, identified as to grade of fuel and gallons involved. If inventories are available, they should be used in computing the net gallons of each grade available for sale.

Unit selling prices should be obtained from the most reliable source available (usually the distributor) and applied to total gallons sold. The resultant sales figures can then be compared with reported sales and a percentage of understatement, if any, computed and applied to sales of motor vehicle fuel reported (Section 0446.20).

ACQUISITION OF EX-TAX GASOLINE

0430.20

While making audits of service stations, auditors should be alert to ex-tax acquisitions of imported gasoline, or stolen gasoline, since the sale of this gasoline is a taxable distribution. Purchase records should be examined to determine whether all fuel was acquired from recognized California distributors, and it should be noted whether the volume of gasoline sold appears to be in balance with the volume of gasoline acquired from recognized California sources. If there are indications that fuel has been acquired illicitly, all available facts should be reported to the Fuel Taxes Division, Special Taxes and Operations Department.

AUDIT OF MOTOR VEHICLE FUEL RETAILERS — PREPAYMENT OF SALES TAX

0431.00

GENERAL 0431.05

Effective July 1, 1986, distributors and brokers subject to the motor vehicle fuel license tax are required to collect prepayments of the retail sales tax from their purchasers on the first distribution and all subsequent transfers of motor vehicle fuel except aviation gasoline in this state. This process continues down to the level of the motor vehicle fuel retailer. Each person making prepayments to suppliers may claim the amount paid as a credit against their sales and use tax liabilities due for the same period.

All routine audits of motor vehicle fuel sellers must include verification of the accuracy of prepayments made and claimed under the "SG" and sales and use tax programs. Since two separate tax programs and funds are involved, it is critical that audit differences attributable to each program be properly identified and uniformly handled.

REPORTING REQUIREMENTS

0431.10

All retailers of motor vehicle fuel subject to the provisions of the "Prepayment of Sales Tax on Motor Vehicle Fuel Program" should be utilizing a modified sales and use tax return (BT–401–GS). This return includes a Schedule G which allows the retailer to:

- claim credit for prepayments made on purchases of MVF,
- claim credit for tax paid to other states.

A net figure is carried forward from Schedule G to Line 21 on the face of the sales and use tax return.

AUDITING PROCEDURES

0431.15

A subsidiary schedule will accompany all gasoline retailers' BT-414-M's (Transcript of Returns Filed — Sales and Use Tax). This schedule will reflect amounts reported and claimed on Schedule G of their returns. Such amounts should be verified along with other return amounts. Schedule G must be completely and correctly prepared to insure proper funding and allocation of tax. Particular attention should be given to:

• Credit for Sales Tax Prepaid to Distributors or Brokers — All credits claimed must be supported by invoices showing the amount of sales tax prepaid to licensed distributors or brokers. Invoices must show the precollection as a separate amount and include the distributor's or broker's "SG" account number. If the "SG" number is not listed on the purchase invoice, it should be verified that the supplier does hold the required "SG" permit. If a separate statement of the precollection is not shown on the invoice, no credit will be allowed. While the proper time to claim the credit is the period in which the purchase has been made (generally, the period in which the invoice date is included), the credit should not be disallowed merely because it was claimed in a subsequent period. It is *critical*, however, that amounts claimed on the return reconcile to the invoiced amounts.

PROCEDURES WHERE RETAILER IS ALSO A DISTRIBUTOR/BROKER 0431.20

All taxpayers holding an "SG" account will have that account examined in conjunction with their related sales and use tax account.

On occasion a distributor/broker will sell gasoline at retail, claim the prepayment credit on their SG return and not pass the credit on to their retail account. Rather than assessing the "SG" account and crediting the related sales tax account, the auditor should comment on the back of the audit report/FBO or on the front of the BT–596 under general comments, that a prepayment offset has been allowed. These comments will assist the Audit Review and Refund Unit in their reconciliation of the sales tax prepayments on MVF by noting that the problem has been addressed.

Where a distributor/retailer makes their first distribution at retail (into the tank of a motor vehicle) and nets the precollection and credit from both the "SG" and sales and use tax return, you need not adjust the return amounts.

LOCAL TAX ALLOCATION

0431.25

Routine audit procedures should be utilized with regard to the examination of the retailer's reported local tax amounts. Since the "Sales Tax Paid to Distributors and Brokers" credit is taken after the local tax allocation has been computed, no special field procedures are required.

BAD DEBTS 0431.30

Retailers who are not distributors or brokers should have no bad debt credits related to prepayments.

ELIGIBILITY FOR REMOVAL FROM PREPAYMENT STATUS

0431.35

Taxpayers who have requested and been removed from prepayment status (as provided in Section 6471), must continue to meet the criteria for removal. It should be verified that the taxpayer continues to qualify: i.e., taxable sales of motor vehicle fuel exceed 75% of their gross receipts. The most recent twelve - month period should be examined. Compliance should be advised of those who no longer qualify.

CLOSE-OUTS 0431.40

The credit for prepayments made to suppliers by the seller of a business <u>CANNOT</u> be transferred to the purchaser of that business. Any prepayment credits remaining at the time of closeout should be claimed on the final return.

WORKING PAPERS 0431.45

Audit workpapers will follow procedures similar to those currently used in adjusting a Section 6406 tax credit. A separate audit schedule should be prepared for each Schedule G line item requiring correction, indexing each schedule as G, followed by the line number of the item being adjusted (e.g., Schedule G4 — Total Sales Tax Paid to Distributors and Brokers). A detailed schedule of differences should also be shown and segregated by month, vendor name and "SG" account number. The audit workpapers showing these differences should accompany the audit report transmitted to the headquarters.

Verification comments should include a discussion of what work was done to verify all items related to Schedule G amounts, i.e., repayment of the one-time credit, credit for sales tax paid to distributors/brokers, carry-over of the one-time credit and credit for tax paid to other states.

SPECIAL MOTOR VEHICLE FUEL TRANSACTIONS

0432.00

RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL

0432.10

A retailer who purchases motor vehicle fuel and adds lubricating oil thereby making premixed fuel which they sell as boat fuel to consumers is technically acting as a distributor. Because of the small quantities of premix blended by such retailers, and the insignificant amounts of gasoline tax involved, it is not administratively practical to require them to be licensed as distributors, post bond, and file monthly returns.

Retailers (usually boat marinas) who purchase motor vehicle fuel and add lubricating oil, thereby making premixed fuel which they sell to consumers are making taxable sales of premix and the entire selling price, including state and federal excise taxes, is subject to sales and use tax.

RETAILERS WHO PURCHASE PREMIX FROM A DISTRIBUTOR

0432.15

The auditor should see that the manufacturer-supplier of premixed fuel is licensed as a distributor, or that wholesaler-supplier of premix fuel is licensed as a broker.

CREDIT CARD SALES

0432.20

The service station dealer is responsible for sales tax on the retail selling price of all motor vehicle fuel and other products sold or delivered by them unless adequate support is maintained for any deduction claimed. Duplicate credit card invoices generally are acceptable in support of exempt transactions.

MASTER CONTRACT SALES

0432.25

Some oil companies enter into master sales contracts with consumers to provide motor vehicle fuel and other products for delivery through company-owned or independent dealer service stations at specified prices. Example of this are the contracts the State of California had with some of the major oil companies for motor vehicle fuel and other supplies.

The oil company becomes the retailer of the fuel sold and delivered at the service station level pursuant to the contract and is responsible for the sales tax on such sales. The independent service station dealer is making sales for resale and should obtain a resale certificate from the oil company involved to cover such sales.

Generally, contract sales are recorded at the service station level on a credit card invoice at the pump price which includes sales tax reimbursement. The purchaser is billed by the oil company at the contract price plus sales tax reimbursement on the contract price. In reporting and paying tax on these sales, the oil company is not allowed to claim a tax-paid purchases resold credit.

If the independent service station operator receives credit from the oil company for the full amount of the credit card charge, the operator will be receiving credit for sales tax reimbursement. Therefore, in addition to maintaining documentation as to the amount of the sale and the fact that it is a sale for resale, the independent service station operator should have records to show that sales tax reimbursement was not received and retained on any portion of the sale. In some cases, this will consist of a computer listing received from the oil company, at the end of each accounting period reflecting the charge back to the dealer of the full amount of sales tax reimbursement on the credit card invoices for master contract sales, and the amount of sales to which the tax applies.

SALES TO U.S. GOVERNMENT

0432.30

Generally these sales are recorded at the service station level on a credit card invoice at the pump price which includes sales tax reimbursement. Since such sales are entirely exempt from sales tax, the service station operator must have documentation to support the deduction. Some oil companies make a charge back to the dealer for the amount of the tax. The charge back is supported by a computer printout notifying them of the amount of sales to the U.S. Government included in their credit card sales. The charge back and printout are acceptable as proof of sales to the U.S. Government.

In some instances, the burden of support for these exempt sales may fall entirely upon the dealer, in which case reliance would be placed on copies of credit card invoices reflecting that the sale was to the U.S. Government and a reduction of the selling price by the amount of sales tax included. Copies of such credit card invoices are acceptable as support for the deduction. It is anticipated that, if necessary, the oil company credit card department will be able to furnish the local dealer with further documentation. In any event, the auditor should insist on adequate support for the deduction.

SALES TO LOCAL GOVERNMENTS

0432.35

Sales to local government entities (cities, counties, and school districts) are made by local service stations at regular pump prices. With the exception of a few local governments which have participated in the State's master contract, these sales generally are not made pursuant to any negotiated contract, and the dealer is responsible for reporting and paying the sales tax. Sales to local governments who have participated in the State's master contract should be handled in the same manner as outlined in Section **0432.25**.

Sales of diesel and special motor vehicle fuels (excludes gasoline) to local governments are exempt from the federal excise tax. However, it is the general practice to bill the total pump price on the credit card sales slip. At the time the credit card invoice is turned into the oil company for credit, the oil company normally credits the dealer for the full amount of the invoice, including sales tax. In turn, the oil company bills the local government the price shown on the credit card invoice less the federal excise tax and charges sales tax reimbursement on the net amount. The oil company then claims the credit as a deduction on its federal excise tax return. This results in a reduction in the sales price of the motor vehicle fuel. If the oil company notifies the local dealer of the amount of federal excise tax not billed to local governments and adjusts its credit to the dealer for the amount of sales tax thereon, the dealer is entitled to adjust his reported gross receipts by the amount of the federal excise tax. If the dealer receives credit for the full pump price plus tax thereon, and no adjustment is made, the dealer will be held responsible for sales tax on the total amount of the sale since the dealer's gross receipts remain unchanged.

Sales of gasoline to local governments are no longer exempt from the federal excise tax for periods after December 31, 1987.

SALES OF GASOLINE FOR USE IN AIRCRAFT

0432.40

Sales of gasoline for use in propelling aircraft are exempt from sales tax provided the distribution and sale of the gasoline is subject to the California motor vehicle fuel license tax and not subject to refund. Since January 1, 1990, no refund of any motor vehicle fuel tax has been granted for fuel used in propelling aircraft. In recent years there has been increasing use of automotive gasoline to propel small aircraft. The automotive gasoline is normally delivered into the aircraft when sold at an airport, however automobile service stations may sell gasoline for use in propelling aircraft and deliver it into the purchaser's storage containers.

The exemption for gasoline delivered directly into the fuel supply tank of an aircraft may be supported by a properly completed sales invoice or an aircraft exemption certificate. If a sales invoice is used, it must show the purchaser's name and address, the aircraft identification number, the number of gallons sold, the price per gallon, the amount of the sale, and the name and address of the seller. If the aircraft fuel is delivered into the purchaser's storage facilities, the exemption should be supported by an aircraft fuel exemption certificate as well as a sales invoice. A suggested form of an aircraft exemption certificate is included in Regulation 1598.

Gasoline used for inflight testing of aircraft is used for propulsion of aircraft and is exempt from sales or use tax. This exemption applies only to gasoline used for *propelling aircraft*. Gasoline used while the aircraft is *stationary* during construction or during the repair, modification, or maintenance of aircraft is not exempt from the tax.

In years past, aviation gasoline was sometimes used in boats, motor vehicles, and stationary equipment. Because of the high price and limited availability of aviation gasoline, these other taxable uses will rarely be encountered.

SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS

0432.45

Effective July 15, 1991, sales of fuel and petroleum products delivered to the purchasing carriers in California are subject to sales tax except as provided by Regulation 1621(b)(3)(B) for air common carriers and 1621(b)(3)(C) for water common carriers. The seller must obtain an exemption certificate (See Regulation 1621) from the common carrier to support the claimed exemption.

SALES TO AUTO LEASING FIRMS

0432.50

Sales of gasoline to firms leasing automobiles on a "wet rental" basis are sales for resale when the lease of the automobile is a "continuing sale". A "wet rental" is one in which the total rental charge includes gasoline furnished by the lessor.

If the lessor has paid sales or use tax with respect to their purchase of a leased automobile, or if the lease is of mobile transportation equipment, the lessor is the consumer of gasoline furnished under a "wet rental," unless the sales price of the gasoline is separately stated from the vehicle rental charge.

Sales of gasoline to lessors for resale should be substantiated in the same manner as other sales for resale. Independent service station dealers should document such resales on credit card purchases with a resale certificate and a copy of the sales slip or statement showing the amount of the sale.

When a lessee on a "wet rental basis" purchases gasoline and is reimbursed by the lessor, the purchase is subject to sales tax since the service station dealer is making a retail sale.

SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT 0432.55

Since leases of mobile transportation equipment are not continuing sales or purchases, the lessor is the consumer of the equipment, and is also the consumer of gasoline furnished under a "wet rental" when such lease is not a "sale or purchase" under the law. The lessor is the consumer whether tax was paid on the cost of the equipment or a proper election was made measure their use tax by the fair rental value of the equipment. Fair rental value does not include amounts attributable to furnishing fuel. However, if the lessor holds themselves out as a retailer of the gasoline by separately stating the selling price of the gasoline, plus the sales tax thereon, from the equipment rental charge, they may properly purchase such gasoline for resale.

REFUND OF SALES TAX ON STATE MVF TAX REFUNDS

0432.60

State motor vehicle fuel tax refunded by the State Controller directly to the consumer is an adjustment to the selling price of the gasoline. A consumer receiving such a refund may also be eligible for a refund under the California Sales and Use Tax Law. The sections of the Sales and Use Tax Law which previously permitted the Controller to refund or collect sales or use tax in connection with these refunds was repealed effective January 1, 1990. Consumers must now claim a refund of the sales and use tax from the retailer and the retailer must claim a refund from the Board.

REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS 0432.65

Refunds of the federal excise tax on gasoline, diesel, or jet fuel to consumers may also result in a refund of the sales or use tax measured by the federal tax refund. The rate of federal excise tax refund depends upon the type of off-highway use Regulation 1598 requires the seller to obtain and a certificate from the purchaser if the purchaser is eligible for and receives a refund of or credit for the federal excise tax. The certificate will relieve the seller of liability for collecting sales or use tax on the amount of measure which represents the federal excise tax.

AUDIT OF FUEL DISTRIBUTORS/BROKERS — PREPAYMENT OF SALES TAX

0433.00

GENERAL 0433.05

On the first taxable distribution in this state of MVF and most fuels subject to Use Fuel Tax, each distributor or broker is required to collect a prepayment of the retail sales tax from the person to whom the motor vehicle fuel is distributed/transferred. Once the prepayment requirement applies, each subsequent seller, other than the retailer, is required to collect and report the prepayment from their purchaser at the same rate.

Each distributor and broker must furnish their customer with a receipt or invoice separately stating the amount of precollected tax. Distributors and brokers are required to show their "SG" account number on their receipts and invoices.

All taxpayers holding an "SG" account, must have this account investigated in conjunction with their related sales and use tax account even though only one or two quarters may be involved. This procedure will facilitate alignment of the "SG" accounts with their related sales and use tax account and ensure that amounts are being properly reported.

Amounts reported under the "SG" program will be posted to a modified BT–414–MVU. This form will be annotated in the upper left-hand corner indicating that scheduled amounts relate to the taxpayer's "SG" returns. If the audit work sheet is prepared in the field, a blank BT–414–MVU should be utilized.

PREPAYMENT CREDITS

0433.10

The amount of prepayment paid by a distributor or broker to their supplier on the purchase of MVF will constitute a credit against the amount required to be collected and remitted to the Board on their prepayment return. Credits are to be taken for the period in which the purchase was made. All credits claimed must be supported by purchase documents, invoices and receipts which separately state the amount of tax prepaid. All purchase documents should be retained in the same manner as other books and records.

AUDITING PROCEDURE

0433.15

An inventory reconciliation should be made to verify that recorded withdrawals are correctly reported in gallons. Total gallons sold (excluding exempt distributions) times the prepayment rate should agree with the reported prepayment of sales tax (Section 0466.10).

In general, the auditor should verify claimed deductions in the same manner as in any other sales tax audit. With respect to exempt distributions to qualified distributors, each office will have on file a list of qualified distributors. This list will be periodically updated by the Excise Taxes Section of the Special Taxes and Operations Department.

On occasion a distributor/broker will sell gasoline at retail, claim the prepayment credit on their SG return and not pass the credit on to their retail account. Rather than assessing the "SG" account and crediting the related sales tax account, the auditor should comment on the back of the audit report/FBO or on the front of the BT–596 under general comments, that a prepayment offset has been allowed. These comments will assist the Audit Review and Refunds Section in their reconciliation of the sales tax prepayments on MVF by noting that the problem has been addressed.

Where a distributor/retailer makes their first distribution at retail (into the tank of a motor vehicle) and nets the precollection and credit from both the "SG" and sales and use tax return, you need not adjust the return amounts.

REPORTING ERRORS 0433.20

When a notified distributor/broker fails to collect the prepayment on their distribution/transfer of MVF subject to the prepayment requirements, but can prove that the full sales tax has been subsequently reported, a notation to that effect should be made in the audit and such amounts should not be determined against the distributor/broker. In such an instance, the distributor or broker should be notified in writing of the precollection requirements. If the distributor/broker has not shown the precollection on the invoice and is unable to prove that the sales and use taxes due have been paid, the amount of unreported precollections should be determined against the distributor/broker.

AUDIT WORKING PAPERS

0433.25

Schedule numbers should correlate with the line numbers on the "SG" return (e.g. Schedule 2a — Ex-tax Fuel Sold to Qualified Distributors). Audited differences for each line category will be forwarded to a "Summary of Differences" Schedule, 414–SG–1.

Audited differences for "Tax Prepaid to California Vendors," should also be forwarded to Schedule 414–SG–1. A detailed breakdown of audited amounts must be provided by month, vendor name and "SG" account number. This schedule should accompany the audit report transmitted to the Audit Review and Refund Unit.

BAD DEBTS 0433.30

A refund of the prepayment may be allowed to any person who is unable to collect the prepayment from the purchaser, insofar as the sales of the fuel are represented by accounts which have been found to be worthless and charged off for income tax purposes. If any of those accounts are thereafter collected by the seller, the gallons of fuel represented by the amounts collected must be included in the next return and the prepayment on those gallons of fuel must be paid to the state. It is important to note that this affects only distributions and transfers of motor vehicle fuel that have occurred on or after July 23, 1987 (MVF) or January 1, 1992 (Other fuels).

LOCAL TAX ALLOCATION

0433.35

No local sales and use tax allocation is involved since no allocation of funds is made until the prepayments are claimed by the retailer.

NEW CAR DEALERS 0433.40

Many new car dealers importing new vehicles into this state with partially filled fuel tanks are making the first taxable distribution of such fuel when the vehicle is sold at retail. Amounts attributable to such importation are generally considered too minimal to warrant registration of such dealers as distributors under the MVF License Tax Law or the "SG" program. However, dealers who purchase gasoline for subsequent retail sale must be coded "G" (MVF retailer) and may require registration as a broker, depending upon the type of operation.

0490.00

ADEQUATE

Fulfilling minimal requirements; satisfactory; acceptable; sufficient.

ANALYZE

To determine or examine the composition of an item, account or amount, usually by reference to its historical origin; particularly (auditing) to review and set forth in a working paper the details or classified summary of items in an account, obtained or substantiated, where necessary, by reference to sources, and accompanied by explanations of major items and by cross-references to related accounts. See SCAN; VERIFY; AUDIT.

APPROPRIATE

Suitable, desirable, reasonable, or necessary in a particular context; often used by accountants as signifying conformity with the value judgments implicit in current practices. See SIGNIFICANT; PROPER.

APPROXIMATE

Containing error; a quantity or verbal characterization which cannot validly be claimed to coincide in all respects with results which might be secured by more precise treatment.

ARITHMETIC MEAN

The result obtained by dividing the sum of two or more quantities by the number of items; usually denoted by a symbol such as Y. It is often intended as a representative quantity or as a measure of the central tendency of a group of items. See AVERAGE; MEAN.

AUDIT

An exploratory, critical review by an auditor of the underlying internal controls and accounting records of a business enterprise or other economic unit, precedent to the expression by him of the opinion of the propriety of its tax returns; often accompanied by a descriptive adjective or phrase indicating scope and purpose.

AVERAGE

- 1. Arithmetic mean.
- 2. Any central tendency of a series of quantities.

See ARITHMETIC MEAN; MEDIAN; MODE; WEIGHTED AVERAGE.

AVERAGE DEVIATION

A measure of the variation of a group of numerical data from a designated point; the arithmetic mean of the differences between each item and the arithmetic mean of the data or other selected point where the differences are added without regard to sign. Thus, the arithmetic mean of 5, 6, and 7 is (5 + 6 + 7/3 = 6) and the average deviation, taken without regard to sign, is (1 + 0 + 1)/3 = 2/3. The smaller the result the more representative the data. See STANDARD DEVIATION; DISPERSION.

BREAK-EVEN POINT

- 1. The volume point at which revenues and costs are equal: a combination of sales and costs that will yield a no-profit, no-loss operation.
- 2. That point in the cost of a variable factor of production at which one or more alternatives are equally economical.

CENTRAL TENDENCY

The pattern displayed by a collection of interrelated data when plotted as coordinates.

CHECK

This is a loose term used in auditing to indicate examination or verification. As a verb, the word has no exact meaning and its use without a descriptive qualification is usually avoided. More descriptive words, such as verify, examine, or prove, are preferable. See TESTCHECK.

CLASSIFICATION

Grouping of transactions, entries, or accounts under a common head or heads; a list of such groupings.

CLERICAL ERROR

As applied to books of account, any incorrect entry or posting, especially when involving routine transactions; typical causes are wrong coding, faulty computation — as in an extension or footing, a failure to enter or post, a posting to a wrong account, and posting to the wrong side of an account.

COMPARE

To establish the correspondence or similarity of differently located items.

CONFIRM

A procedure used to obtain added proof through contracts or communications with independent sources to establish the correctness of situations or transactions; for example, establishing losses of merchandise from fire or theft.

CROSSCHECK

- 1. To add horizontally as well as vertically in order to assure the accuracy of totals.
- 2. To perform one operation, as in auditing, which will have the effect of aiding in determining the accuracy, property, or other characteristic of another operation.

DETAILED AUDIT

An examination of the books of account, or a portion thereof, whereby all or substantially all entries and transactions are reviewed and verified, as contrasted with an examination by means of tests or samples. See AUDIT; SAMPLE; TESTCHECK.

DISCREPANCY

Any observed difference between opinions or facts, often with the implication of an error or other impropriety in one or more of them.

DISPERSION

A measure of the variation of a group of numerical data from a central tendency, such as arithmetic mean, by determining the range of such data or their average deviation or standard deviation. See these terms.

EXAMINE

To probe records or inspect securities or other documents, procedures and scope, for the purpose of arriving at opinions of accuracy, propriety, sufficiency, and the like.

INTERNAL CONTROL

This consists of measures and methods employed within an organization to safeguard cash, inventories and other assets as well as to maintain the accuracy and proper functioning of the accounting system. This is of paramount importance in tax auditing since an efficient system of internal control can make the auditor's tests easier and more reliable.

JUDGMENT SAMPLE

A sample whose size and items composing it has been determined by someone who is familiar with the universe undergoing the test and capable of exercising informed and unbiased discretion in making the selection. Such samples are sometimes necessary when data are needed quickly or when interest is confirmed to only a part of the universe. They are usually less reliable for estimation and prediction purposes than are samples selected on a wholly random basis.

MARKDOWN

The reduction of an originally established selling price.

MARKDOWN CANCELLATION

The portion of original markon restored after a markdown has been made.

MARKON

The amount added to cost, in setting selling prices, to cover operating expenses and profit margin; the ratio to selling price of the amount added to cost, expressed as a percentage; formerly known as "markup".

MARKUP

- 1. The amount added to an established selling price for the purpose of determining a new and higher selling price; the percentage of markup is based on the previously established selling price.
- 2. The total amount by which established selling prices are increased during a given period in setting new selling prices.
- 3. = markon.

The Board usage of markup is synonymous with the meaning of markon and is the amount <u>added to cost to obtain the sale price</u>, and generally is referred to in terms of percentages. The percentage of markup is computed by dividing gross profit by cost of sales: G.P./C.G.S. = % of M.U. Businessmen often discuss gross profit in terms of percentages, but seldom discuss markup in these terms. Care should be exercised by auditors to make certain they are on common ground with the taxpayer when discussing gross profit and markup percentages.

MARKUP CANCELLATION

The elimination of a markup or such portion thereof as pertains to referent unsold merchandise. The removal of a previous addition to an established selling price. Markup cancellation is not to be confused with Board's usage of the "markup" definition. See MARKUP.

MARKUP FACTOR

This is the factor by which cost of sales is multiplied to determine total sales: C.G.S. x M.U.F. = S. The markup factor always will be the percentage of markup plus 100%. In computing sales, the markup factor should be used as it saves one step (adding the amount of the markup to cost of sales) in the computation of sales. The markup factor is obtained by dividing sales by cost of sales: S./C.G.S. = M.U.F.

MATERIALITY

- 1. The relative importance or relevance of any item included or omitted from a financial statement, or of any procedure or change in procedure that conceivably might effect such a statement.
- 2. The characteristic attaching to a statement, fact, or item whereby its disclosure or the method of giving it expression would be likely to influence the judgment of a reasonable person.
- 3. The relative importance of any audit coverage, such as the testing of certain accounts. The opinion can be reached only by a value judgment on the part of the auditor.

MEAN

A midpoint in an array of numbers. See ARITHMETIC MEAN.

MEDIAN

The central item in a list of numbers arrayed according to size; the value at which on equal number of items fall on either side in a list of numbers so arrayed; often represented by the symbol Md.

MODE

The item of most frequent occurrence in a group of numbers; often represented by the symbol Mo; the class of greatest frequency in a frequency distribution. See MEDIAN; ARITHMETIC MEAN; AVERAGE.

OBJECTIVE

Having a meaning or application apart from the investigator, the peculiarities of his experience, or of the environment, and substantiated or capable of being substantiated by the findings of independent investigators; said of a fact, judgment, or inference; as objective evidence. See SUBJECTIVE.

PRELIMINARY AUDIT

In an initial engagement, the investigation of the business and its accounting system and operating methods preceding the determination of the scope of the audit procedures to be employed.

PROBABILITY SAMPLE

A random sample with a computable sampling error. The computed error indicates the degree of representativeness (or lack thereof) which should be taken into consideration in interpreting the sample results.

PROCEDURAL AUDIT (or REVIEW)

The critical examination by an auditor of internal controls and other procedures employed within an organization, (a) looking a recommendations for their improvement whether by simplification, elaboration, or readaptation, or (b) as a regular feature of a periodic examination. Frequently, the review involves procedures other than accounting.

PROPER

In line with common practice; meeting specifications deemed fitting in the circumstances; ethical as well as legal.

PROVE

To verify or subject to a satisfactory test.

PROVE FOOTINGS

Footings are the sums obtained from vertical or horizontal additions, or both, and are used by the auditor to establish the accuracy of the totals. It usually is sufficient for tax audit purposes to verify the additions on most taxpayer's records to the closest \$100. However, where the footings being verified are used to compute percentages based on tests, they should be verified to the closest dollar.

RANDOM

Arising from chance alone, in contrast with haphazard or systematic. Randomization requires careful planning to make certain that only chance elements are present, or that bias, if present or introduced, is known and measurable.

RANDOM NUMBERS

A set of numbers formed at random; generally arrayed in tabular form to assist in sample selection.

RANDOM SAMPLE

A sample in which all the elements have been drawn at random, or according to the laws of chance. The procedure by which the sample is constructed characterizes a random sample, rather than its specific content. See STRATIFIED SAMPLING; SYSTEMATIC SAMPLING; REPLICATION.

RANDOM VARIATION

A fluctuation resulting from chance alone.

RANGE

The difference between the largest and smallest items in a group of numerical data. See DISPERSION.

RECONCILE

To account for difference between separate sources of information for the same transaction. The tax auditor often will be confronted with differences between the taxpayer's records, tax work sheets, and returns filed.

RELIABILITY

- 1. (Auditing) The measure of confidence that may be placed in a set of records or reports. See REPLICATION.
- 2. (Statistics) Relative ability to repeat results in a given set of trials or experiments.

REPLICATION

The repetition of methods by which evidence is gathered. Thus, if under similar conditions of selection and verification, two independent examinations are made of a group of vouchers, each is a replication of the other, although the particular vouchers examined may not be the same.

The replication of audit methods may be regarded as a test of precision with which the procedures were carried out. See VALIDITY.

REPRESENTATIVE SAMPLE

Any random sample selected for observation, whether or not containing a determinable error. See PROBABILITY SAMPLE.

REVIEW

To examine critically any operation, procedure, condition, event, or series of transactions.

SAMPLE

A portion of a group of related transactions, financial statements, or other universe of data chosen to reflect or assist in determining the accuracy, propriety, or other characteristics of the whole. Sampling is an important element in the process of auditing. See TESTCHECK.

SAMPLING ERROR (Statistics)

Standard error of a sampling distribution.

SCAN

To look at the entries in an account, accounting record, or a group of accounts or records, for the purpose of testing general conformity to pattern, noting apparent irregularities, unusual items, or other circumstances appearing to require further study. The term indicates a general and rapid review as opposed to a detailed examination or substantiation of each item, and often a review requiring the skill of a practiced auditor and having as its purpose the discovery of the qualitative aspects of a procedure, classification, or account. See ANALYZE.

SCOPE

The character of an audit, primarily with reference to the procedures utilized in a particular audit, or the extent to which the transactions, records, or accounts examined serve as a basis of adequate testing and substantiation.

SHELF TEST

This is a general term for procedures used to determine the unit price of merchandise sold. In many instances this is done by examining unit prices of merchandise on the shelves of the retailer. Unit sales prices also may be determined by examining catalogs, sales tickets, menus, contracts, etc.

SIGNIFICANT

- 1. Of sufficient magnitude, as measured by a departure from some norm or standard, to raise doubt that the deviation is the result of chance, random, or compensating factors; hence, indicating behavior calling for a better awareness or understanding of the cause, the removal of the cause, or a modification of the standard because of its inadequacy.
- 2. Of sufficient importance to warrant disclosure or the treatment accorded larger or more important items; likely to influence judgments or decisions; said of individual transactions, transaction groups, or other events or conditions peculiar to a given establishment.

SIGNIFICANT AMOUNT

A rounded-off number, as of dollars, conveying to the observer the same impression as would the fully expressed quantity.

SPECIAL AUDIT

An audit, having a special or general scope, for other than the regular periods or for other than customary purposes; a limited audit. See AUDIT.

STANDARD DEVIATION (Statistics)

A measure of dispersion: the square root of the average of the squares of the differences between a group of numbers and their arithmetic mean.

While other measures of dispersion, such as range and average deviation, are available, the preferred measure of dispersion in statistics is the standard deviation.

STATISTIC

Any value, such as an arithmetic mean, median, or standard deviation, calculated from a sample rather than a universe.

In accounting practice, "statistics" are sometimes distinguished from accounting data by the fact that the former may not tie in directly with the books of account and thus be subjected to the discipline of double-entry bookkeeping.

STRATIFIED SAMPLING (Statistics)

Drawing of random samples within strata of relatively homogeneous subgroups of the population. Generally, the strata are sampled independently so that sample results in one strata do not affect sampling procedures in other strata. The data may also bed classified into strata on the basis of cost, ease, facility of handling materials, and other criteria, as well as statistical homogeneity.

SUBJECTIVE

Having a meaning or application reflecting the characteristics of the investigator, the peculiarities of his experience, or of the environment, and not substantiated by independent investigators: said of a fact, judgment, or inference.

SUBSTANTIATE

To insure the accuracy of, by weight of evidence; to verify.

SYSTEMATIC SAMPLING (Statistics)

A sample design or set of sampling procedures, frequently employed, wherein sampling units are selected at some fixed and designated interval, e.g., every fifth file card in a file system. A systematic sample qualifies as a random sample if the starting element is selected at random and every k th element (k, an integer) of the frame is selected thereafter.

TEST

- 1. A specified procedure or set of procedures, including rules or assembling evidence, interpretation, and significance for accepting or rejecting hypotheses.
- 2. As applied to the quality of a commodity or of a performance, a sample or sampling.

TESTCHECK

To verify selected items in an account or record for the purpose of arriving at an opinion of the correctness of the entire account or record; to sample. See SAMPLE; TEST.

TESTED

Records are examined to the extent deemed appropriate.

TESTING

The justification for testing rests largely upon the probability that irregularities are recurrent; that, once committed, they will be reported.

TRACE

To ascertain whether an item has been disposed of in accordance with source indications. The tracing of transactions is a necessary phase of the tax auditor's verification and is particularly important when establishing differences in test periods.

UNIVERSE

- 1. The whole of the subject matter of whatever is under consideration.
- 2. (Statistics) The entire matrix or group of data from which samples may be drawn; sometimes referred to as a population.

VALIDATE

- 1. To test for or to certify or attest to accuracy, precision, reliability, and relevance.
- 2. To do what is necessary to make effective or legal.

VALIDITY

As used in deductive logic; propriety established by a strong inference in which no inconsistency appears.

VERIFICATION

- 1. The procedure by which validity is ascertained.
- 2. The process of substantiation involved in providing by customary audit procedures that a statement, account, or item is accurate and properly stated, or to be within permissible or reasonable limits.

VERIFICATION OF POSTINGS

Verification of postings involves tracing original records to the books or original entry whose totals are than traced to postings in the general ledger.

VERIFY

To confirm the truth, accuracy, or probability of, by competent examination; to substantiate.

WEIGHTED AVERAGE

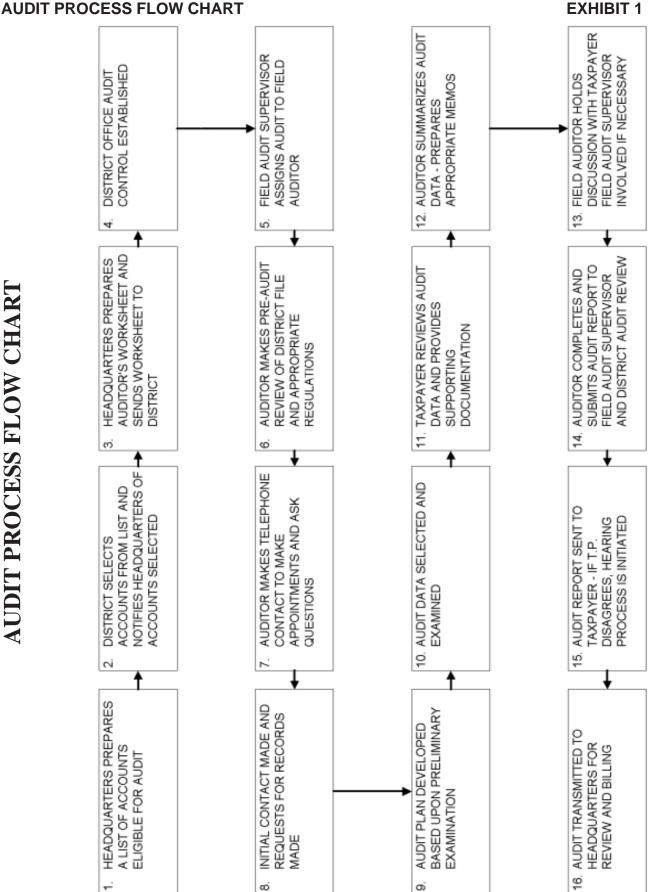
A simple average of items reduced to a common basis.

ACKNOWLEDGMENT

The principal source of the definitions included in this glossary appears below:

Eric L. Kohler, A DICTIONARY FOR ACCOUNTANTS, 3rd Ed., (C) 1963. Reprinted by permission of Prentice-Hall, Inc., Englewood Cliffs, New Jersey.

AUDIT PROCESS FLOW CHART



FORM BT-1164 — AUDIT MEMORANDUM OF POSSIBLE TAX LIABILITY EXHIBIT 2

BT-1164 REV. 10 (3-92) AUDIT MEMORANDUM OF POSSIBLE TAX LIABILITY	STATE OF CALIFORN BOARD OF EQUALIZATION		
То:	Auditing		
From:BUYER'S — FILE	— Auditing SELLER'S — FILE		
Account No.	Account No		
Name	Name		
Address	Address		
Phone ()	Phone ()		
Purchase	Shipped		
Order No	From		
(Buyer) (Seller) states that a (resale) (exemption) certificate was issued by the but (Sales) (Use) tax was remitted to seller when paying Tax (not added) (incorrectly computed). Other (describe)	uyer for tools and supplies. the indicated ex-tax invoices.		
Date Invoice No.	Amount Description of Merchandise		
See schedule attached.	Occupation in		
Above Listing covers Period to			
Comments and Recommendations:			
Prepare in duplicate and give original to supervisor. Duplica (Refer to A.M. Sections: 0401.20 & 0408.20)	te to be retained with audit.		

FORM BT-1032 — INFORMATION OUT-OF-STATE RETAILERS

EXHIBIT 3

INFO	REV.3(10-92) RMATION ON OUT-OF-STATE RETAILERS Out-of-State Compliance	Date	STATE OF CALIFORNIA BOARD OF EQUALIZATION
FROM	И :		
1.	Purchaser (or buyer)		
	Name	Account Number	
	Street		
	City and State		
2.	O/S Retailer (or vendor)	Account	
	Name	Account Number	
	Street		
	City and State		
3.	Sales Representative	Account	
	Name		
	Street		
	City and State		
4.	Date of Invoice	5. Invoice I	Number
6.	Amount of Purchase		
7(a)	Amount of California Use Tax reported by the pur	rchaser	
(b)	Amount of California Use Tax included in audit of	purchaser	
8.	Description of Property Sold		
9.	How Sale was Solicited		
10.	Other Information		
All ite	re in duplicate ms should be completed. Pre	pared by	

POLICY AND PROCEDURE FOR SUBPOENA REQUESTS

EXHIBIT 4

POLICY AND PROCEDURE FOR SUBPOENA REQUESTS SUBPOENAS DUCES TECUM

Authority and Use. The Board of Equalization is authorized by Section 15613 of the Government Code to issue a subpoena for the attendance of witnesses or the production of books, records, accounts and papers. A subpoena requiring a person to bring books, records, accounts and papers with them is called a "subpoena duces tecum." When in the course of a field audit or investigation of a taxpayer's business, the Board's representative is denied access to business records which are necessary in order to carry out the functions of the Board, the subpoena power may be invoked. The subpoena should be considered only when the records are known or believed to exist, the potential liability to be revealed by the records is significant, and all other methods of obtaining the records have been unsuccessful.

Procedure. All subpoenas will be prepared by the Legal Division in Headquarters utilizing information provided by the district. Districts should prepare the request in the form of a memorandum from the District Administrator to the Chief of Field Operations. The Chief of Field Operations will forward approved requests to the Legal Division for drafting and issuance.

Information Needed. The memorandum should include the following information:

- a) The taxpayer(s) name, dba(s), address, and tax number(s) applicable to the records being requested.
- b) The name and address of the person or entity upon whom the subpoena is to be served.
- c) The name and title of the Board employee who will examine the documents.
- d) The Board address where the documents are to be examined.
- e) If necessary, a date and or time when the records are to be produced or examined. A date/time may be appropriate if the employee who will examine the records will be available only before or after a certain date. Normally the Legal Division will calculate and specify the appropriate dates based on time frames which are controlled by statute.
- f) The time period covered by the documents that are being requested.
- g) The specific documents that are being requested. Request only the records needed for the audit. Do not state "any and all records" or similar omnibus requests.
- h) The efforts that have already been made to obtain the documents being sought. Attach copies of letters written, and indicate whether the request was ignored or refused.
- i) If service is being made on a financial institution for production of a customer's financial records, the California Right to Financial Privacy Act requires that the customer affected also be served with a copy of the subpoena, and have a period of time in which to notify the financial institution of intent to move to quash the subpoena. Therefore, the following additional information is required:
 - customer's name, address, and account number at the financial institution
 - character of the customer —
 - corporation
 - corporation that has forfeited its charter or right to do business or that has dissolved
 - joint stock company or association
 - partnership
 - unincorporated association

- public entity
- minor
- fiduciary guardian, conservator, trustee, executor, etc.
- candidate for election for public office
- any other natural person not described above.

The above information is necessary in order that the subpoena and the declaration of materiality under penalty of perjury supporting the issuance of the subpoena may be prepared with the degree of particularity necessary to insure against infringements of the taxpayer's constitutional guarantees relating to unreasonable search and seizure and due process of law.

Preparation and Service of Subpoena and Declaration. The Legal Division will prepare the Subpoena Duces Tecum, Declaration, Notices and Acknowledgment of Receipt, and Proofs of Service. The documents will be sent to the District Administrator together with complete instructions for serving the subpoena. Subpoenas being served on financial institutions for the production of customer records include instructions to the financial institution to estimate and obtain approval of their research and copying charges before complying with the subpoena. The instructions provided by Legal must be followed exactly to protect the rights of both the taxpayer and the Board.

SAMPLE SALES TAX WORKING PAPER (WHOLE DOLLAR AUDITING) EXHIBIT 5

							SCHEDULE 1	PAGE
		Who	ole Dollar Audítí	ng			ACCOUNT NO.	
							AUDITOR J. BY	
							DATE 1/19	
		A	В	С	D	E	F	G
ļ			Audited					
1		Sales Per	Sales of			W/D		
		Records	Fíxed Assets	Total	Reported	Varíances	Differences	
ļ	REFERENCE							
	2— xx	428465		428465	428466	- 1		
	3-XX	475150		475150	475145	5		
	4-xx	367481	1000	368481	367482	- 1	1000	
		1271296	1000	1272096	1271093	3	1000	
							<414-A2>	
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6								
7								
8								
9								
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1								
2								
3								
5								
6								
7								
8								
9								
0								
1		T	137					1
2		Instructiona	al Note:					
3		By using th	ne whole-dollar	technique, tl	he audited sale	es may vary	slightly from	
4			d sales. Differe					
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STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA (P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)



MEMBER

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Tax Permittee

Use of XYZ Letter Procedure to Verify Claimed Sales for Resale

This letter summarizes the sample letter procedure explained to you by our auditor. The auditor questioned certain sales claimed on your tax returns as sales for resale because they were not supported by a valid resale certificate taken in good faith at the time of sale.

Under the California Sales and Use Tax Law, you as the seller are liable for payment of the tax unless you can present satisfactory evidence that the property was in fact purchased by your customer for resale or that your customer paid the tax directly to this state.

The attached sample letter and statement form are provided for your convenience. You may customize the letter by placing the text on your letterhead, but do not change or delete any information provided in the sample. You may reproduce the statement form and send it to the customers in question to obtain their signed statements regarding the disposition of the purchased property. The statement form provided to you by the auditor must not be changed. The auditor will provide return envelopes to you so that your customer's reply can be sent directly to the Board.

The auditor will allow a two to four week period during which you must send the statements and your customers must reply. Statements received within the allowed period will be carefully considered by the auditor. A statement will not be accepted as satisfactory proof if incomplete or if found to be untrue or if the purchaser did not hold a seller's permit at the time of sale.

Please be aware that, unlike a valid resale certificate, a purchaser's statement of resale taken after the sale does not relieve the seller of liability for the tax if it is found that the property was purchased for the buyer's use and the applicable tax was not paid to the state prior to the date of your letter to your customer. The Board will not accept your customer's statement if it has or receives information that refutes such statement.

STATE BOARD OF EQUALIZATION Sales and Use Tax Department

BT-504-B REV.10(3-93)

STATE OF CALIFORNIA BOARD OF EQUALIZATION

SAMPLE LETTER Requesting Purchaser's Statement

XYZ Company 1234 5th Street Los Angeles, Califomia 90013

Auditors of the California State Board of Equalization are currently examining our records in connection with the California Sales and Use Tax Law. They have questioned certain nontaxed sales made to you, as covered by the invoices listed on the attached sheet.

Would you please indicate the disposition of this property by checking the appropriate box and completing the statement. The Board will not accept the statement if it is not filled out completely and signed by an authorized representative.

Your prompt response is necessary for us to support any claims for exemption that are in order. Please return the inquiry statement within 10 days of the date of this letter directly to the State Board of Equalization using the enclosed envelope.

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

STATEMENT CONCERNING PROPERTY PURCHASED WITHOUT PAYMENT OF CALIFORNIA SALES TAX

Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made from the seller listed below. Please fill out the form completely, check the appropriate boxes, and sign as your company's authorized representative. The form should be returned within 10 days to the State Board of Equalization using the envelope provided.

NAME OF SELLER FR	OM WHOM YOU PUR		SELLER'S PERMIT NO		
DATE	INVOICE NUMBER	PURCHASE ORDER NUMBER	AMOUNT	DESCRIPTION	
Please check one	e of the boxes be	elow. If one of the f	irst four boxes i	s checked, please enter	your sales tax permit number below.
					personal property. It was not used for in the regular course of business.
The above than reter	e property was partion, demonstrat	urchased for resale ion, or display while	and is presently being held for	y in resale inventory. It I sale in the regular cours	nas not been used for any purpose other se of business.
		urchased for your o		as paid directly to the B	oard with our sales tax return for the
	e property was p tax returns.	urchased for leasing	g and tax meas	ured by rental receipts h	as been paid directly to the Board with
The above	e property was p	urchased for our ow	n use and not f	or resale.	
COMMENTS					
PURCHASER'S PERM	/IIT NUMBER			PURCHASER'S NAME	
SIGNATURE				TITLE	
DATE		PHONE			CITY

The information provided above is subject to verification by the State Board of Equalization

Exhibit 7 to be published at a later date with Section 0411.00

Account Number SP

Area Code

999

FOR HEADQUARTERS USE ONLY

BT-379 REV. 3 (1-86) STATE BOARD OF EQUALIZATION AIRCRAFT EXEMPT SALE REFERRAL

To:	Occasional Sales Unit					
From:	: District Copies of invoice and/or supporting documents attached					
Purcha	aser:					
	FIRST	MIDDLE	LAST			
Addres	SS:	STREET NUMBER				
	CITY	ZIPCODE	COUNTY			
Aircraf	t					
	cation: Make:	_ Reg.No: N	Year:			
Place	of Delivery					
Seller:		Sales Price:				
Addres	SS:	N Number of Trade-i	n			
City: _		Date of Sale				
Sale c	laimed exempt by seller as a:					
☐ Sa	le to nonresident of California: or,					
☐ Sa	le to a common carrier or foreign go	vernment				
□ Ех	emption Certificate (attach copy)					
☐ _{Pu}	rchase Order (attach copy)					
Miscel	laneous Information:					
Prepar	red by:	FOR H	EADQUARTERS USE			
Date:		Due Date:	Due Date:			

General Audit Procedure / Chapter 4 / September 1995

FORM BT-837 — AFFIDAVIT FOR SECTION 6388 OR 6388.5 EXEMPTION EXHIBIT 9

BT-837 (5-86)

STATE OF CALIFORNIA BOARD OF EQUALIZATION

AFFIDAVIT FOR SECTION 6388 OR 6388.5 EXEMPTION FROM THE CALIFORNIA SALES AND USE TAX

Vehicle Serial No	Year	Unladen Weight (At lease 6000 lbs)				
Manufacturer and Place of Manufact	ure	Date of Delivery				
I hereby certify that the vehi	cle listed above, w	hich I purchased or took delivery from				
			(California Dealer's or Manufacturer's Name)			
located at			, has been licensed and/or registered			
	Dealer's or Manufacture	r's Address - Street, City, State, Zip Code)				
(State other tha	ın CA)	·				
(Affidavit not valid unless wri license acceptable)	itten evidence of o	ut-of-state license and/or registration is at	ttached. California base plate with prorate			
Additionally. (Please check a	appropriate box)					
	outside California, a	·	ve listed vehicle from a dealer located outside side California within 30 days from the date that			
• • • • • • • • • • • • • • • • • • • •	•	ed pursuant to Section 6388 – New or re in California by the manufacturer or rem	manufactured vehicles purchased from out-of- anufacturer.			
semitrailer outside	I hereby certify that for trailers and semitrailers manufactured outside California, I have moved or driven the trailer or semitrailer outside California within 30 days from the date it was delivered to me in California and that I will use it exclusively outside California, or exclusively in interstate or foreign commerce, or both.					
Applies	Applies to exemption claimed pursuant to Section 6388.5 (See below for description)					
I hereby certify that for trailers and semitrailers manufactured in California, I have moved or driven the trailer or semitrailer outside California within 75 days from the date it was delivered to me in California and that I will use it exclusively outside California, or exclusively in interstate or foreign commerce, or both.						
Applies to exemption claimed pursuant to Section 6388.5 – New or remanufactured trailers or semitrailers delivered in California by the manufacturer, remanufacturer, or dealer.						
the event that I used the veh even though I have provided	icle other than outs the manufacturer, Tax Law to report	ide California, or in interstate or foreign or remanufacturer, or dealer with the require	e appropriate period as described above, or in commerce, or both (whichever is applicable), ed affidavit, I understand that I am required by e Board of Equalization, measured by the			
Date Certification Given	Signed b	/ (Name of Purchaser and Title)				